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IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

SHEARN MOODY, JR.,
Petitioner,

v.

DAVID C. MEYERS, *et al.*,
Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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QUESTIONS PRESENTED

1. Whether the federal courts in this case should have abstained from deciding claims that collaterally attacked determinations made by state insurance regulators.
2. Whether the court of appeals exceeded its authority by declaring principles of general law at variance with governing state law.
3. Whether the principles set forth in *Bangor Punta Operations, Inc.* v. *Bangor & Aroostook Railroad*, 417 U.S. 703 (1974), barring the use of the federal courts to obtain windfall recoveries, are inapplicable to windfalls for which the plaintiffs ostensibly bargained.

PARTIES TO THE PROCEEDING

This litigation was commenced by the filing of two shareholders' derivative suits. Plaintiffs in the first suit, suing on behalf of Empire Life Insurance Company of America and Credit Factoring, Inc., were Bernard Haines, Louis Mast, William Sosniak, and Jack Sosniak. Named as defendants were Shearn Moody, Jr., Empire Life Insurance Company of America, and Credit Factoring, Inc. Plaintiffs in the second suit, suing on behalf of Empire Life Insurance Company of America, were David C. Meyers, Frank Habicht, and Peter N. Todhunter. Named as defendants were Shearn Moody, Jr.; Clay Cotton, Commissioner of Insurance for the State of Texas; Tom I. McFarling, temporary receiver for Empire Life Insurance Company of America; E. V. Omholt, Montana receiver of Empire Life Insurance Company of America; John G. Bookout, Alabama receiver of Empire Life Insurance Company of America; E. Gene Sykes, Arkansas receiver of Empire Life Insurance Company of America. These suits were eventually dismissed. The remaining suit was filed by John G. Bookout, as statutory receiver on behalf of Empire Life Insurance Company of America, against Shearn Moody, Jr.

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

Shearn Moody, Jr., petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Fifth Circuit in this case.

OPINION BELOW

The opinion of the court of appeals is reported at 693 F.2d 1196. The opinion is reprinted as Appendix A in the separate Appendix to this petition. The opinion of the district court is reported at 475 F. Supp. 232. It is reprinted as Appendix B in the separate Appendix to this petition.

JURISDICTION

The judgment of the court of appeals was entered on December 23, 1982. The court of appeals denied a petition for rehearing and rehearing *en banc* on March 1, 1983. On May 12, 1983, Justice White extended the time for filing a petition for a writ of certiorari to and including June 20, 1983. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATEMENT

This lawsuit was filed against petitioner, a former majority stockholder, director and officer of Empire Life Insurance Company, seeking to impose liability for certain activities ordered or approved by the Alabama Department of Insurance.[1] After a jury verdict for respondent, the district court entered a judgment against petitioner for $5,319,000 in compensatory damages and $1,000,000 in punitive damages. The court of appeals affirmed.

The events giving rise to the suit began in 1963. In June of that year, petitioner incorporated Empire Life Insurance Company ("Empire") in the State of Alabama. Pet. App. 3. The following month, petitioner assigned to Empire 40 per cent of his interest in the Libbie Shearn Moody Trust, a trust whose principal asset was nearly ten million shares of stock in American National Insurance Company.[2] In return for that interest, petitioner received an unpaid debenture for $200,000. Pet. App. 3.

The valuation of the trust interest lies at the heart of the dispute. Under Alabama law, as in other states, the valuation of assets of an insurance company is the responsibility of the Department of Insurance. 28 Ala. Code § 61 (1959); Ala. Code §§ 27-37-1 *et seq.* (1977). While an insurance company must provide the Department with financial statements and other necessary information, the Department of Insurance must ultimately determine the extent of liabilities and the availability of assets to cover them. In 1964, Alabama law provided that "[t]he superintendent of insurance shall allow to the

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[1] The complaint alleged claims under the federal securities laws, as well as state claims. Jurisdiction over the state claims, the only claims on which the court of appeals grounded liability, was predicated on theories of pendent jurisdiction and diversity jurisdiction.

[2] American National Insurance Company was, and is, one of the largest stock life insurance companies in the United States. See DX 37.

credit of an insurance company, in the account of its financial condition, on such assets as are or can be made available for the payment of losses in Alabama." 28 Ala. Code § 61 (1959).

The valuation of a life interest is a mixture of art and science. Since a life interest terminates, of course, on the death of the beneficiary, the first variable to be considered is the age of the beneficiary and, with the guidance of actuarial tables, his life expectancy. The evaluator must then determine the likely stream of income to be received during the term of the life estate, a calculation that in this case involved projections regarding future dividend distributions from American National Insurance Company. Once this figure has been calculated, it must be discounted for the effects of inflation in order to arrive at a present value. See Pet. App. 4. After consideration of these factors, the Superintendent in 1964 valued the life interest held by Empire at $5,813,440. Pet. App. 4-5.

Early in 1965 American National Insurance Company announced an increase in its dividend. Pet. App. 5. Since that increase changed one of the variables for determining the value of the trust interest, Empire provided the Department of Insurance with revised figures showing a range of different values for the trust interest. After these figures were reviewed by Alabama insurance examiners, a formal valuation hearing was held before the Superintendent of Insurance. Pet. App. 7-8. The Superintendent then determined that the life interest should be valued at a figure of $14,213,440. DX 6.[3]

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[3] Throughout its opinion the court of appeals mistakenly says that the Superintendent placed a value of $14,403,200 on the life interest, strongly implying that he adopted one of the figures submitted to him by the Company. See, e.g., Pet. App. 7, 10, 15, 21, 22, 37 and DX 64. In fact, after his own review of the figures, the Superintendent placed a lower value on the life interest, which Empire subsequently observed. DX 6.

This figure remained unchanged for the next three years, during which time Empire made numerous acquisitions. The Department of Insurance, as required by Alabama law, reviewed each of the acquisitions to determine whether they jeopardized the financial stability of the Company. For these purposes, the Department continued to value the life interest at the $14 million figure. Each of the acquisitions was approved by the Department. See e.g., DX 43A, DX 44, DX 47.

Had these events been the extent of the story, no lawsuit would have ensued. But in 1969, an appraisal prepared by the American Appraisal Company suggested alternative valuations for the life interest of $8,600,000 (for continued use) and $4,250,000 (for orderly liquidation). Pet. App. 10. A second Superintendent of Insurance rejected those figures, issuing an administrative order expressly authorizing Empire to carry the life interest at an asset figure of $14.2 million. DX 19.[4] In 1972, however, a third Superintendent revived the earlier appraisal and ordered that the life interest be carried at a figure of $4,250,000, a revision that caused Empire to become insolvent under statutory accounting principles. Pet. App. 11. The Superintendent made no finding that the life interest was incorrectly valued in 1965, concluding only that, as of the date of his determination, a different value was appropriate.

Thrown into financial convulsion by the sudden change in valuation, Empire was placed into receivership in June 1972. Pet. App. 11. Eighteen months later, the receivership court ordered that Empire be liquidated and approved a bulk reinsurance agreement with Protective Life Insurance Company ("Protective"). Pet. App. 11.

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[4] The order, noting that petitioner's life expectancy decreased as he got older, provided for the establishment of a reserve fund to be increased annually and required the maintenance of adequate insurance on petitioner's life. DX 19.

This lawsuit, instituted on behalf of Empire in 1974,[5] in essence attacks the decision to value the life interest at $14 million and to pursue a series of acquisitions based upon that figure. Although petitioner has consistently noted that the valuation was set, and the acquisitions approved, by the Alabama Department of Insurance, the district court declined to defer to those judgments, electing to consider the reasonableness of such actions on a *de novo* basis. The jury thus heard expert testimony on much the same issues as the Superintendent of Insurance had resolved years before. Apparently concluding that the higher valuation and the subsequent acquisitions had been unreasonable, the jury awarded over six million dollars in damages under federal and state law. Pet. App. 12.

The court of appeals took the same approach. Putting aside the claims under federal law, the court concluded that the valuation and subsequent acquisition program were sufficient to sustain common law claims of mismanagement and breach of fiduciary duty. Pet. App. 20-25. Like the district court, the court of appeals gave no weight to the fact that the Alabama Department of Insurance had made the determinations at issue. Rather, the court fashioned its own rule to govern the case, stating: "An insurance company may not delegate responsibility for valuation of its assets to a state agency, and the mere fact that an insurance commissioner accepts a company's asset valuation does not immunize the company from liability arising from that valuation." Pet. App. 22 n.11.

The court also declined to apply the principles of *Bangor Punta Operations, Inc. v. Bangor & Aroostook Railroad*

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[5] Two shareholders' derivative suits were brought on behalf of Empire in 1972. After this derivative action was filed, with the Receiver serving pursuant to Alabama statute (Ala. Code § 27-32-15(a) (1975)), the shareholders' actions were dismissed. Pet. App. 12 & n.7.

Co., 417 U.S. 703 (1974), to this case. Although this Court in *Bangor Punta* disapproved the use of federal courts to secure windfall profits, the court of appeals concluded that *Bangor Punta* was inapplicable where the plaintiff had bargained for the windfall. Pet. App. 16-18.

REASONS FOR GRANTING THE WRIT

The decision of the court of appeals, while set in the framework of an action for damages, is in fact a collateral attack on several determinations committed by state law to the Alabama Department of Insurance. During the period from 1965-1970, the Department not only concluded that Empire Life Insurance Company was entitled to carry an assigned life interest on the books for $14.2 million but then approved a series of acquisitions by Empire based upon that figure. No challenges to those decisions were made then or later in the Alabama courts. Instead, respondent filed a suit in federal court for damages nine years after the valuation and six years after the last acquisition, claiming that the valuation and acquisitions were unreasonable. The courts below, showing little or no deference for the role of the State agency, agreed.

This belated judicial review suffers from several defects. To begin with, in declaring that companies (and their officers and directors) may be found liable for decisions made by state agencies, the court of appeals has introduced a rule of law that will unsettle relations between businesses and state officials for years to come. Even more importantly, the decision puts the federal courts in the role of second-guessing the decisions of state administrators, a role for which they are ill-situated and ill-suited. This seizure of authority is particularly inappropriate here for it occurs in the complex field of insurance regulation, which Congress has emphatically entrusted to the primary care of the states.

We believe that the decisions of this Court counsel a different course. See, *e.g.*, *Fair Assessment in Real Estate*

Ass'n, Inc. v. McNary, 454 U.S. 100 (1981); *Alabama Public Service Comm'n v. Southern Ry. Co.*, 341 U.S. 341 (1951); *Burford v. Sun Oil Co.*, 319 U.S. 315 (1943). In such cases, the Court has held that federal courts should refrain from exercising jurisdiction where its exercise would intrude on state regulation of essentially local matters. See also *Hawks v. Hamill*, 288 U.S. 52 (1933). By the same token, the Courts of Appeals for the First and Second Circuits have recognized that abstention is particularly appropriate in the area of insurance. See *Allstate Insurance Co. v. Sabbagh*, 603 F.2d 228 (1st Cir. 1979); *Smith v. Metropolitan Property & Liability Insurance Co.*, 629 F.2d 757 (2d Cir. 1980). The same deference to state regulation should have been accorded here.

We also believe that, even if jurisdiction was properly exercised, the court of appeals improperly applied law of its own invention. It is well-established, of course, that a federal court exercising pendent or diversity jurisdiction over state claims must apply state law in the same manner as a state court would do. See *Erie Railroad Co. v. Tompkins*, 304 U.S. 64 (1938). Despite these principles, however, the court of appeals felt free to fashion its own rule, directly contrary to state law, that determinations by state administrative agencies could be set aside in a private suit for damages. This judicial lawmaking flies in the face of nearly fifty years of decisions by this Court forbidding federal courts to create "federal common law" in pendent and diversity cases.

Finally, the court of appeals devised a novel exception to the principles set forth by this Court in *Bangor Punta Operations, Inc. v. Bangor & Aroostook Railroad Co.*, 417 U.S. 703 (1974). Although the Court made clear in *Bangor Punta* that the federal courts should not be used to obtain windfall recoveries, the court of appeals found those principles inapplicable to windfalls for which the plaintiff had ostensibly bargained. The exception is unwarranted and unwise.

I. The Decision Below Is Inconsistent With Decisions Of This Court And Other Courts Of Appeals Requiring Deference To State Administration of State Programs.

Whether phrased in terms of comity, abstention, or equitable discretion, this Court has long emphasized "[t]he scrupulous regard for the rightful independence of state governments which should at all times actuate the federal courts." *Matthews v. Rogers*, 284 U.S. 521, 525 (1932); *Fair Assessment in Real Estate Ass'n, Inc. v. McNary*, *supra*, 454 U.S. at 111. In setting aside state determinations, and imposing liability on petitioner for acting in accordance with those determinations, the courts below showed no such "scrupulous regard."

The requirement of deference to state activities, as the Court has recently noted, is grounded in a "continuance of the belief that the National Government will fare best if the States and their institutions are left free to perform their separate functions in their separate ways." *Younger v. Harris*, 401 U.S. 37, 44 (1971), quoted in *Fair Assessment in Real Estate Ass'n, Inc. v. McNary*, *supra*, 454 U.S. at 112. Faced with repeated invitations to disregard or discredit state efforts, "federal courts must be constantly mindful of the 'special delicacy of the adjustment to be preserved between federal equitable power and State administration of its own law.'" *Rizzo v. Goode*, 423 U.S. 362, 378 (1976), quoting *Stefanelli v. Minard*, 324 U.S. 117, 120 (1951). "It is in the public interest that federal courts of equity should exercise their discretionary power to grant or withhold relief so as to avoid needless obstruction of the domestic policy of the states." *Great Lakes Dredge & Dock Co. v. Huffman*, 319 U.S. 293, 298 (1943).

Even where the jurisdiction of the federal courts has been invoked for the advancement of federal rights, this Court has warned against needless intrusion into state programs. Thus, the Court has admonished that "the National Government, anxious though it may be to vindicate

and protect federal rights and federal interests [should] always endeavor[] to do so in ways that will not unduly interfere with the legitimate activities of the States." *Younger v. Harris, supra*, 401 U.S. at 44. This admonition, of course, applies with even greater force when the rights asserted are not federal rights at all but rights based on state law. As Justice Cardozo has written for the Court, "[r]eluctance there has been to use the process of federal courts in restraint of state officials though the rights asserted by the complainants are strictly federal in origin. * * * There must be reluctance even greater when the rights are strictly local * * *." *Hawks v. Hamill, supra*, 288 U.S. at 61.

These principles are more than historical musings. In putting these principles into effect, this Court has ordered the outright dismissal of certain cases thought particularly intrusive on local concerns. See *Burford v. Sun Oil Co., supra*; *Alabama Public Service Comm'n v. Southern Ry. Co., supra*. In *Burford*, for example, the Court ordered that a challenge to a drilling order of the Texas Railroad Commission be dismissed, observing that "it 'is in the public interest that federal courts of equity should exercise their discretionary power with proper regard for the rightful independence of state governments in carrying out their domestic policy.'" *Id.* at 318, quoting *Commonwealth of Pennsylvania v. Williams*, 294 U.S. 176, 185 (1935). Noting that Texas had a fully adequate administrative and judicial scheme for challenging such orders, the Court stated: "These questions of regulation of the industry by the State administrative agency * * * so clearly involve basic problems of Texas policy that equitable discretion should be exercised to give the Texas courts the first opportunity to consider them." 319 U.S. at 332. Similarly, in *Alabama Public Service Commission*, the Court held that "[a]s adequate state court review of an administrative order based upon predominately local factors is available to appellee, intervention of a federal court is not necessary for the protection of federal rights."

341 U.S. at 349. Pointing to the "usual rule of comity," the Court concluded that "[w]hatever rights appellee may have are to be pursued through the state courts." *Id.* at 350. See also *Louisiana Power & Light Co. v. Thibodaux*, 360 U.S. 25 (1959); *Colorado River Water Conservation District v. United States*, 424 U.S. 800 (1976).[6]

There is, of course, no bright line to separate activities of particular importance to the states from other activities deemed less important. But, at this point in the history of federal-state relations, it is virtually beyond dispute that regulation of insurance companies, the matter at issue here, is a subject of unusual sensitivity to the states. As the Court has recognized, for at least 75 years prior to 1944, "regulation of insurance transactions was thought to rest exclusively with the States." *Securities and Exchange Commission v. National Securities, Inc.*, 393 U.S. 453, 458 (1969). After the decision in *United States v. South-Eastern Underwriters Ass'n*, 322 U.S. 533 (1944), which cast doubt upon the issue, Congress promptly passed the McCarran-Ferguson Act, 59 Stat. 34 (1945), as amended, 15 U.S.C. § 1011 *et seq.*, to reaffirm the primary role of the states in regulating the business of insurance. That role has continued essentially undiminished to the present time.[7]

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[6] While these principles generally evolved in cases seeking equitable or declaratory relief, this Court has recently made clear that they apply to suits for damages as well. In *Fair Assessment in Real Estate Ass'n, Inc. v. McNary, supra*, the Court reasoned that the determinations necessary to sustain an action for damages "would be fully as intrusive as the equitable actions that are barred by principles of comity." *Id.* at 113. The Court pointed out that "damages actions, no less than actions for an injunction, would hale state officers into federal court every time a taxpayer alleged the requisite elements of a § 1983 claim." *Id.* at 115. The controlling question in every case, therefore, is not whether the suit seeks damages or an injunction but whether it needlessly interferes with regulatory or other activities of particular importance to the state.

[7] The McCarran-Ferguson Act leaves little doubt about the limits of federal intervention into insurance matters. In its first section,

The decision of the court of appeals in this case does considerable violence to these policies. Without any effort to divine actual or likely state law on the subject, the court first announced a rule that administrative determinations do not affect the liability of companies relying on them. Pet. App. 22 n.11.[8] To make matters worse, it proceeded to reopen the questions decided by the state agency, ultimately concluding that the decisions were erroneous. Pet. App. 22. As a result, petitioner has been subject to liability on legal grounds that have no identifiable basis in state law and on factual grounds that are in conflict with findings of a state agency.[9] This judicial venture has effectively made the state decisions meaningless.

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for example, Congress expressly declared that "the continued regulation and taxation by the several States of the business of insurance is in the public interest." 15 U.S.C. § 1011. The Act then provides that "[n]o Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance * * * unless such Act specifically relates to the business of insurance * * *." 15 U.S.C. § 1012(b). This Court in *National Securities* observed that "[t]he relationship between insurer and insured, the type of policy which could be issued, its reliability, interpretation, and enforcement—these were the core of the 'business of insurance.'" 393 U.S. at 460. The issue of valuation of assets, in turn, goes directly to the question of the "reliability" of a company's insurance policies, since it determines what assets are considered to be available for the payment of claims.

[8] Rejecting arguments to the contrary as "spurious," the court stated: "An insurance company may not delegate responsibility for valuation of its assets to a state agency, and the mere fact that an insurance commissioner accepts a company's asset valuation does not immunize the company from liability arising from that valuation." Pet App. 22 n.11. The court cited no authority for this proposition.

[9] Although the Department of Insurance later required the life interest to be carried at a lower valuation (see page 4, *supra*), it did not attempt to revise the earlier valuations retroactively. It is the *retroactive* change in valuation, supplied by the court of appeals, that is at issue here.

The legal questions decided by the court of appeals, far from being peripheral issues, lie at the heart of the state regulatory process. If it is true that "[a]n insurance company may not delegate responsibility for valuation of its assets to a state agency," as the court of appeals declared, then the final word on valuation of assets must necessarily rest with the insurance companies themselves, not the state agencies. In that case, it might naturally follow that, as the court of appeals also concluded, "the mere fact that an insurance commissioner accepts a company's asset valuation does not immunize the company from liability arising from that valuation." But, if those issues are decided the other way, and the decisions of the state agency are deemed controlling, then the balance of responsibility shifts markedly. It is just that sort of issue that the state courts, rather than the federal courts, are better positioned to decide.[10]

It scarcely helps matters that the views of the court of appeals are almost certainly wrong. Even a cursory reading of state law shows clearly that the Alabama Department of Insurance is, and long has been, given ultimate responsibility for the valuation of assets. 28 Ala. Code § 61 (1959); Ala. Code §§ 27-37-1 *et seq.* (1977). Since state law has imposed that duty, no delegation from the companies is needed or even possible. Once a valuation has been set, the companies are then bound to respect that valuation and may be subject to shareholder suits if they let assets languish.

We also believe that the state courts would be far more likely to support agency findings in the face of collateral attack. Even where direct attacks are concerned, for example, Alabama law requires that an order of the Insurance Commissioner "be taken as just and reasonable."

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[10] This Court, of course, has also recognized that uncertainty about state law is an independent reason justifying abstention. See, e.g., *Railroad Comm'n of Texas v. Pullman*, 312 U.S. 496 (1941); *Louisiana Power & Light Co. v. Thibodaux, supra.*

Ala. Code § 27-2-32 (1975). Furthermore, "[i]t is an accepted principle that [t]he rule which forbids the reopening of a matter once judicially determined by competent authority applies as well to the judicial and quasi-judicial acts of public, executive, or administrative officers and boards acting within their jurisdiction as to the judgments of courts having general judicial powers." *State v. Brooks*, 53 So.2d 329, 333 (Ala. 1951) (internal quotes omitted). See also *City of Huntsville v. Goodenrath*, 68 So. 676 (Ala. 1915). Since the acts of the Alabama Commissioner are expressly made quasi-judicial, Ala. Code § 27-2-31(a) (1975), we seriously doubt whether the Alabama courts would recognize a cause of action for damages based on a claim that earlier factual determinations of the Commissioner were unreasonable.[11] At the very least, the Alabama courts should have the opportunity to make that choice for themselves.[12]

The evils of the court of appeals' rule are well demonstrated in this case. While the suit did not directly challenge the actions of the Alabama Department of Insurance, the claims in the end invited the federal courts to determine that those actions were wrong.[13] It is undisputed that the events giving rise to this lawsuit were the valuation of the life interest in 1965 and a series of acquisitions from 1965-1968 (see Pet. App. 14); it is

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[11] At one point, the court of appeals seems to imply that it would permit imposition of liability even if the administrative determinations were *reasonable*. Pet. App. 22-23. Again, no authority is cited for this proposition and, so far as we are aware, none could be.

[12] Alabama law on these points is hardly out of step with other jurisdictions. See cases cited at note 19, *infra*. Indeed, in a case quite similar to this one, a three-judge federal court held that an administrative determination was binding even on subsequent *administrators* and that it could not be collaterally attacked. *Modern Woodmen of America v. Casados*, 17 F. Supp. 763 (D.N.M. 1937).

[13] As the court of appeals itself noted, "there was only one wrong complained of and proved: the manipulation of the life interest leading to fatal undercapitalized acquisition * * *." Pet. App. 27.

likewise undisputed that the Department of Insurance, after review by its examiners and a hearing on valuation, decided to admit the life interest at a value of $14.2 million and that the Department subsequently approved each of the challenged acquisitions. Pet. App. 7-8; DX 6, DX 43A, DX 44, DX 47.[14] Yet, notwithstanding these administrative decisions and the absence of any challenge to those decisions in state court, the court below felt free to conduct a *de novo* review of the wisdom of the determinations and to conclude that they were "unreasonable." Pet. App. 22. This sort of second opinion suspends insurance companies between competing factfinding bodies.

Had the 1965 valuation or the later acquisitions prompted a direct and immediate challenge in federal court, we think that the principles of noninterference established in *Burford* and *McNary* would have required its dismissal. See also *Allstate Insurance Co. v. Sabbagh*, *supra*, and *Smith v. Metropolitan Property & Liability Ins. Co.*, discussed at pages 16-17, *infra*. It should hardly benefit respondent that, instead of filing an immediate direct challenge, it chose to make a collateral attack in the form of an action for damages some nine years later. To begin with, as the cases cited above indicate (see page 13, *supra*), it is well recognized that a collateral attack may not do service for a direct appeal or act as a way around neglected procedural requirements. But, in any event, the interference with state regulatory efforts is, if anything, even greater in such a case since a suit for damages not only requires a finding that the administrative deter-

[14] The court of appeals does make the gratuitous suggestion that the Superintendent of Insurance "might have been swayed by considerations of friendship and obligation in approving the increased valuation of the life interest." Pet. App. 8 n.4. In so surmising, however, the court ignored not only the established presumption that officials act in a proper manner (*see, e.g., United States* v. *Chemical Foundation, Inc.*, 272 U.S. 1, 14-15 (1926)), but also the fact that a subsequent Superintendent reached the same conclusion despite the submission of other possible valuation figures. See page 4, *supra*.

minations were wrong but exacts an after-the-fact penalty for acting on the basis of those determinations. Indeed, it is to prevent this sort of uncertainty that both Alabama and Texas have required challenges to insurance rulings to be made in a single, specified state court. See Ala. Code § 27-2-32 (1975) ("circuit court of Montgomery County, Alabama"); Texas Ins. Code Ann. art. 1.15, § 4 (Vernon 1981) ("any state district court located in Travis County, Texas").[15]

The intrusion on state regulation might be worth the cost if the federal courts had something particular to contribute, but the reverse is true. It merely states the obvious to say that the federal courts have no notable expertise in valuations for insurance purposes. As the opinion of the court of appeals aptly demonstrates, the valuation of a life interest depends upon choices made among a number of variables, including life expectancy, projected income streams, and anticipated inflation rates. See Pet. App. 4. In concluding that the trust interest was overvalued, the court of appeals simply advanced its own view, with the not inconsiderable benefit of hindsight, on the proper resolution of an issue resolved differently by the Department of Insurance seventeen years before.[16]

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[15] The presence of the unaddressed federal securities claims does not change our view. The intrusion on state affairs would be just as great, for example, if a stockholder sought to challenge an administrative valuation by suing the insurance company for including that valuation on its balance sheet. We see no reason why the federal courts in such a case should have a license to force insurance companies to choose, at their peril, between an administrative finding and a judicial one.

[16] For example, the court of appeals relied, among other things, on "ANICO's subsequent earnings history" as support for a more conservative valuation. Pet. App. 22. The court also announced its view that "the $14,403,200 valuation was clearly unreasonable in relation to the life interest's income," Pet. App. 22, although the same figures regarding trust income were before the Superintendent when he made his determination that the $14 million figure *was* reasonable. We also note that in the period from 1964-75, Empire re-

Whether or not the court of appeals is right, a point on which experts may eternally differ, the fact remains that the substitution of federal judges for state administrators turns the regulation of insurance companies on its head.

The willingness of the Fifth Circuit to meddle in these issues is in marked contrast to the position taken by the First and Second Circuits. See *Allstate Insurance Co. v. Sabbagh*, *supra*; *Smith v. Metropolitan Property & Liability Ins. Co.*, *supra*. See also *Construction Aggregates Corp. v. Rivera de Vicenty*, 573 F.2d 86 (1st Cir. 1978); *Barry v. St. Paul Fire and Marine Ins. Co.*, 555 F.2d 3 (1st Cir. 1977), aff'd, 438 U.S. 531 (1978). In *Sabbagh*, for example, the First Circuit upheld, on the basis of *Burford v. Sun Oil Co.*, *supra*, the decision to abstain from a challenge to automobile insurance rates established by the Massachusetts Commissioner of Insurance. The court noted that, like the courts in *Burford* and *Alabama Public Service Commission*, it was "dealing with an area of intensely local interest." 603 F.2d at 233. Furthermore, it observed that, as was the case here, "[t]his case would inevitably involve detailed factual analysis of the bases of the Commissioner's decision and [plaintiff's] efforts to prove the Commissioner's decision unjustified." *Ibid.* The court concluded that any such review could be better conducted by the state courts. *Id.* at 233-34.[17]

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ceived nearly $2.5 million in dividends from the life interest, *Empire Life Insurance Co. v. Moody*, 584 S.W.2d 855, 859 n.2 (Tex. 1979), and it has received substantially more since then.

[17] The First Circuit in *Construction Aggregates* also took special care not to create avenues of relief in federal court where none would exist in state court. The court observed: "[Appellant] has not cited any statute or authority granting to the Puerto Rico courts jurisdiction to entertain an attack on an Insurance Fund rate in any other manner. If the laws of Puerto Rico do not recognize a cause of action permitting a collateral attack on these rates, a federal court in the exercise of its diversity jurisdiction would be unable to enter-

The court in *Smith* followed a similar course, upholding the decision to abstain in a suit challenging the validity of an exclusionary clause in an automobile insurance policy. First noting that state law on the issue was unclear, the court went on to emphasize that the state had a vital interest "in the doctrinal integrity of its regulatory scheme." 629 F.2d at 760. The court pointed out that federal interference might have "a severe disruptive impact on the state regulatory apparatus," *id.* at 761, finally concluding: "The fact that the insurance industry is heavily regulated makes it all the more important that we stay our hand in favor of a definitive and uniform interpretation from the state courts. Abstention is particularly appropriate when dealing with a complicated and comprehensive regulatory statute intended to strike a balance between differing local interests." *Id.* at 761 (internal quotes and citations omitted).[18]

In valuing the assets of an insurance company, state regulators necessarily must "strike a balance between differing local interests." If assets are valued too high, the protection afforded to policyholders will be eroded. On the other hand, if assets are undervalued, the ability of insurance companies to provide insurance coverage,

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tain any such claim." 573 F.2d at 96. The court of appeals in the present case made no effort at all to determine whether the Alabama courts would permit a suit of this sort.

[18] These cases strongly suggest that the mischief of the decision below, while ample in its own right, cannot readily be confined to this particular case. For, if a plaintiff may seek damages in federal court based upon his disagreement with agency determinations, then the true effect of agency decisions cannot be known until such suits are finally resolved. Thus, for instance, an insurance company might become subject to class actions by policyholders for charging rates previously approved by state regulators or to suits for enforcing policy exclusions allowed by state regulators, even though no direct challenge to such rates or exclusions had ever been made in state court. In light of such continuing uncertainty, it will become increasingly difficult for states to establish a coherent system of insurance regulation.

and thereby compete for insurance customers, will be arbitrarily cut back. Thus, in addition to the usual difficulties associated with valuing assets, insurance commissioners must decide, on grounds of policy, whether they will tolerate certain risks in exchange for more extensive competition. Once those choices have been made, they should not be subject to either direct or collateral attack in federal court.

This is plainly a case where "intervention of a federal court is not necessary for the protection of federal rights." *Alabama Public Service Comm'n v. Southern Ry. Co., supra*, 341 U.S. at 349. The decision to exercise jurisdiction was thus an improper interference with state efforts to regulate insurance companies.

II. The Court Of Appeals Improperly Substituted Its Own Views For The Applicable State Law.

Even if the courts below properly decided to exercise jurisdiction, they were required to apply state law to the state law claims. *Erie Railroad Co. v. Tompkins*, 304 U.S. 64 (1938). Yet, on the crucial question regarding the 1965 valuation, the court of appeals seemingly made no effort to do so, instead announcing its own erroneous view that state factfinding does not affect the liability of insurance companies.[19] This casual lawmaking is pre-

[19] The Court's sweeping and summary disposal of the pivotal question of law (see note 8, *supra*), while perhaps an eloquent statement of its sense of what the law *ought* to be, flatly contradicts what the States of Texas and Alabama have decreed that the law *shall* be. In Texas (whose law the court of appeals generally applied on other questions) collateral attacks on agency determinations, in private suits for damages and otherwise, are forbidden. *Bolton v. Coats*, 514 S.W.2d 482 (Tex. Civ. App. 1974); *Railroad Commission v. McKnight*, 619 S.W.2d 255 (Tex. Civ. App. 1981); *Railroad Commission v. Marathon Oil Co.*, 89 S.W.2d 517 (Tex. Civ. App. 1935); *Kirby Lumber Co. v. Adams*, 62 S.W.2d 366 (Tex. Civ. App. 1933). The law in Alabama is to the same effect. See cases cited at page 13, *supra*. Not even by alleging that an administrative finding was procured by the defendant's own false statements as evidence

cisely the sort of judicial enterprise that *Erie* was intended to stop.

Few legal principles have been stated as plainly as the principle established in *Erie:* "[t]here is no federal common law." *Id.* at 78. Not only does Congress "ha[ve] no power to declare substantive rules of common law applicable in a state * * *," *id.* at 78, but "no clause in the Constitution purports to confer such a power upon the federal courts." *Id.* at 78. Rather, this Court instructed that "[e]xcept in matters governed by the Federal Constitution or by acts of Congress, the law to be applied in any case is the law of the state." 304 U.S. at 78.

The reasons for the rule are many and various. To begin with, the so-called "general law" of the federal courts often has amounted to "little less than what the judge advancing the doctrine [thought] at the time should be general law on a particular subject * * *." *Baltimore & Ohio R.R. v. Baugh*, 149 U.S. 368, 401 (1893) (Field, J., dissenting). In addition, creation of general principles introduces a lack of uniformity into the law, making the effects of commercial transactions more uncertain and the incentives to forum-shopping more seductive. 304 U.S. at

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can a plaintiff prevent a defendant from "relying on the order as a shield of liability." *Bolton v. Coats, supra*, 514 S.W.2d at 487.

As the Texas Attorney General pointed out in his *amicus* brief supporting a rehearing *en banc*, the court of appeals' "non-delegation" language was simply a way of phrasing a rule of law directly contravening the Texas and Alabama rules. *Brief Amicus Curiae of the State of Texas in Support of Appellant's Suggestion for Rehearing En Banc* at 6-7. "It is the state, acting pursuant to its responsibility to protect the public, that delegates responsibility for the valuation of assets. The insurance companies do not delegate any responsibility; insurance regulators value assets because the law of the state *requires* them to, not because the company *requests* them to." *Id.* at 7 (emphasis in original). The proposition that the court of appeals rejected as "spurious" was not a proposition invented by petitioner; rather, it was the law that would have been applied had this case been brought in state court.

74. Finally, the imposition of federal common law injures not only private litigants, but the states themselves, and hence the structure of constitutional government. As Justice Field had observed many years before *Erie*, "nothing can be more disturbing and irritating to the states than an attempted enforcement upon its people of a supposed unwritten law * * * to which they have never assented and which has no existence except in the brain of the Federal judges in their conceptions of what the law of the states should be on the subjects considered." *Baltimore & Ohio R.R. v. Baugh*, *supra*, 149 U.S. at 403 (Field, J., dissenting).[20]

The decision of the court of appeals here simply returns the allocation of lawmaking power to its condition before *Erie*. Although the court obviously did not disavow *Erie*, its statement of a broad general principle, without any grounding in or reference to state law, produces the same practical result. If the court of appeals had carefully considered the relevant state authorities, and if it had then rejected them as "spurious" on the ground that they conflicted with a general rule that "an insurance company may not delegate responsibility for valuation of its assets to a state agency," it would clearly have violated *Erie* and the Constitution. Since the basis for *Erie* is that the federal courts lack *jurisdiction* to make law,

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[20] Indeed, perhaps the most significant aspect of the decision in *Erie* was its formal recognition that the Constitution can be violated by the conduct of the federal courts themselves, independent of any unconstitutional legislative or executive actions. *Erie Railroad Co. v. Tompkins*, *supra*, 304 U.S. at 79-80; see C. Wright, Handbook on the Law of Federal Courts § 56 at 259 (3d ed. 1976). "It is impossible to overstate the importance" of this holding, which "announces no technical doctrine of procedure or jurisdiction, but goes to the heart of the relations between the federal government and the states, and returns to the states a power that had for nearly a century been exercised by the federal government." C. Wright, *supra*, § 55 at 255.

except where jurisdiction has been delegated by the Constitution and by Congress, a covert or careless usurpation of state lawmaking power is no less unconstitutional than an open and intentional one.

The damage done by the usurpation here is particularly acute because it transfers decisionmaking authority from an administrative agency to a court. In deciding that the Alabama Insurance Commissioner shall decide on the value of insurance company reserve assets, the State of Alabama chose to delegate this authority to an accountable public official chosen for specialized knowledge and competence in the insurance field. By decreeing that his findings can be overridden by a federal court, the court of appeals transferred decisionmaking power to a body whose members are chosen without any regard for their knowledge of the insurance industry, and who are given life tenure precisely so that they will not be politically accountable. Even if it were preferable for decisions about insurance regulation to be made by life-tenured generalists rather than by politically-accountable specialists, a proposition that we doubt, the point is that the transfer of decisionmaking power is a substantial one that restructures Alabama's regulatory scheme in important ways. If, as petitioner contends, the court below had no authority under state law to effect such a transfer, then its decision to do so is a serious error that deserves correction.

Although it may be presumed that federal courts often make common law by simply erring in their reading of state law, this case involves more than a mere misstep. Here, the court of appeals did not even attempt to apply state law to the question on which the case turned. That disregard is particularly inappropriate in this case for not only are there relevant authorities but they mandate the opposite result. See note 19, *supra*. Finally, we

note that the manner of ignoring state law—sweeping aside contentions about the specific positive law of a state with a general statement about what the law must be—suggests a return to precisely the judicial attitudes and habits that *Erie* condemned.

These departures can ultimately be curtailed only by this Court. This Court recognized recently in *Milwaukee v. Illinois*, 451 U.S. 304, 317 n.9 (1981), that "[s]ince the states are represented in Congress but not in the federal courts, the very concerns about displacing state law which counsel against finding pre-emption of *state* law in the absence of clear intent actually suggest a willingness to find congressional displacement of *federal* common law." In this case—where the issue is whether a federal court has displaced state lawmakers in an area incontestably outside the legitimate scope of federal common law—the same concerns should prompt a broad willingness by this Court to review and scrutinize claims that the federal courts have exceeded their constitutional authority.

The Court, in fact, exhibited precisely that willingness in several cases decided after *Erie*. In those cases, the Court readily reversed decisions by federal courts that, while acknowledging the obligation to apply state law, in fact decided crucial points without reference to applicable state decisions. See *Texarkana v. Arkansas Louisiana Gas Co.*, 306 U.S. 188 (1939), and *Equitable Life Insurance Co. v. Halsey*, 312 U.S. 410 (1941). In *Texarkana*, for example, the court of appeals had found it "perfectly plain" that a certain contract clause was "completely invalid and unenforceable as an attempt to abdicate and delegate" a legal duty. 97 F.2d at 9. This Court, however, reversed on the ground that the "perfectly plain" proposition had been decisively rejected by the Texas Supreme Court. 306 U.S. at 201-02. Similarly, the court of appeals in *Equitable Life* cited no state cases for its

pivotal holding but simply declared: "We see no reason why appellant should be held accountable," since a certain clause in a contract "constituted a valid defense." This Court again reversed, noting that the Supreme Court of Iowa had held otherwise. 312 U.S. at 423-426. The lesson of *Erie*, then, is that the federal courts must in fact apply state law, not merely pay lip service to it.

The tendency of federal courts to invent their own law has continued to occupy the attention of this Court. For example, the Court recently recognized and attempted to curtail the use of broadly-worded federal statutes as devices for the transformation of federal courts into courts of general common law. In *Parratt v. Taylor*, 451 U.S. 527 (1981), this Court rejected a lower federal court's attempt to enact the principle that "loss should not go without redress" into a federal law imposing liability on state officials under 42 U.S.C. § 1983. While suggesting that this axiom "would be an admirable provision to be contained in a code," the Court observed that there is "no general common law applicable to federal courts" and that the case must be resolved "not simply with a single, general principle, however just that principle may be in the abstract, but with the complex interplay of the Constitution, statutes, and the facts which form the basis for this litigation." *Id.* at 531-32. Similarly, in *Paul v. Davis*, 424 U.S. 693 (1976), this Court rejected any construction of the Due Process Clause that would "make of the Fourteenth Amendment a font of tort law to be superimposed upon whatever systems may already be administered by the states." *Id.* at 701. It would make little sense to allow federal courts, constrained by admonitions against replacing state tort law with their own preferred general principles under the authority of the Constitution or a federal statute, to accomplish exactly the same result under the rubric of interpreting state law.

III. The Decision Below, by Allowing Respondent A Duplicative Recovery, Is Inconsistent With The Decision Of This Court In *Bangor Punta Operations, Inc. v. Bangor & Aroostook Railroad Co.*, 417 U.S. 703 (1974).

As the court of appeals has recognized, the recovery in this case will go, not to Empire, but to Protective Life Insurance Company. Pet. App. 17. Since Protective has already reaped the benefit of acquiring Empire's assets under the auspices of the receivership, the judgment here is precisely the sort of windfall condemned in *Bangor Punta Operations, Inc. v. Bangor & Aroostook Railroad Co., supra.*

In *Bangor Punta*, this Court struck down a suit by a corporation against its former owner, where "the real party in interest and the principal beneficiary of any recovery" was the new owner of the corporation. In explaining why such a suit could not go forward, the Court relied on the "settled principle of equity that a shareholder may not complain of acts of corporate mismanagement if he acquired his shares from those who participated or acquiesced in the allegedly wrongful transactions." 417 U.S. at 710. As the Court stated, this broad rule applies "with special force where a shareholder purchases all or substantially all the shares of a corporation from a vendor at a fair price, and then seeks to recover *against that vendor* for prior corporate mismanagement." *Id.* (emphasis added).

The Court noted that a verdict for the plaintiff under such circumstances would produce two complementary inequitable results. First, the new owner of the corporation would receive a "windfall," because he would have paid a depressed price for the company due to the prior mismanagement, and then would also have received, through the corporation's suit, compensation for that mismanagement, which injured him not at all. *Id.* at 711-12.[21] Second, where the defendant was also the former

[21] The need to prevent new shareholders from "reap[ing] a profit from the wrongs done to others," *id.* at 711, may be viewed as the

sole or majority shareholder, that defendant would be doubly punished for his wrongdoing. As *Bangor Punta* recognized, 417 U.S. at 172, when such a shareholder mismanages a company, he does the injury, as it were, to himself. *See also In Re REA Express Inc., Private Treble Damage Antitrust Litigation*, 412 F.Supp. 1239, 1252 (E.D. Pa. 1976). Since that self-inflicted injury is reflected in the depressed sale price received, *id.*, a subsequent lawsuit can only have the "practical effect" of requiring the former owner to "pay twice" for his wrongdoing. See *National Union Electric Corp. v. Matsushita Electric Industrial Co.*, 498 F. Supp. 991, 1002 (E.D. Pa. 1980).

Those principles come into full play here. Just as in *Bangor Punta*, petitioner is a former majority owner of a company, facing a lawsuit for mismanagement brought in the name of the corporation by its new "owner." [22] Here, under the reinsurance agreement between the receiver and Protective, the role of the nominal corporate plaintiff is merely as a conduit because the contract guarantees that the bulk of any lawsuit proceeds will pass through the corporation and go directly to Protective. Thus, the real beneficiary in this case, as in *Bangor Punta*, is simply seeking to recover for alleged corporate

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central purpose of the *Bangor Punta* rule. *Rock River Savings and Loan Association v. American States Insurance Co.*, 594 F.2d 633, 635 (7th Cir. 1979). It is a need that comes into play whenever a company is sold for a price that is depressed due to previous misconduct and the buyer then seeks to recover for that misconduct. *E.g., id.*; *Courtland Manor, Inc. v. Leeds*, 347 A.2d 144, 148 (Del. Ch. 1975).

[22] In *Bangor Punta*, of course, that owner was a purchaser in a conventional stock sale, whereas, here, petitioner lost his interest in Empire Life through a combination of a receivership and a reinsurance agreement transferring the policies and assets to a competitor (Protective). Yet this difference does not alter the fundamental fact that each case includes a real party in interest *other* than the named corporate plaintiff. And it is clear that a reinsurance agreement is effectively a "sale." *Kentucky Central Life Insurance Co. v. Commissioner*, 57 TC 482, 496 (1972).

mismanagement when the same mismanagement was the basis for its acquisition on depressed terms. That recovery would seem to be a windfall of the purest sort.

The court of appeals, however, declined to apply *Bangor Punta*, finding an exception where the buyer ostensibly "bargained for" the litigation proceeds. Pet. App. 17-18. We do not believe that any such exception exists. Although one court has recognized that a buyer and seller may include a valuable cause of action in their calculations of the appropriate price, that court properly limited the exception to cases in which the cause of action lies *against third parties*, not the former owners of the company. *National Union Electric Corp. v. Matsushita Electric Industrial Co.*, *supra*, 498 F. Supp. at 1002. Indeed, any broader exception would make little sense. It will surely be the rare case where a seller of a corporation sells with it a right to sue himself for an unknown and unknowable amount of damages. And even if, for some reason, the effects of mismanagement were a separate item for discussion, it would be far more desirable to have a rule that requires the buyer and seller to decide the price of such mismanagement through negotiation, or through arbitration, than by agreeing to institute or extend litigation in the federal courts.

In any event, the exception fashioned by the court of appeals is wholly inapplicable to this case. While the court apparently believed that the policyholders of Empire would be the beneficiaries of the recovery, the jury expressly found that the policyholders suffered no injury. Interrogatory No. 11. Thus, not one cent of the judgment is intended to reimburse the policyholders. Moreover, it is now clear that the policyholders will not get one cent since any obligation of Protective to pay them has ended.[23] It is Protective, and Protective alone, that the judgment will enrich.

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[23] It is now a matter of public record that Protective has no obligation to pay any of the recovery to policyholders of Empire. See *Protective Corporation Annual Report, 1982, at 24.*

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

SHEARN MOODY, JR.,

Petitioner,

v.

DAVID C. MEYERS, ET AL.,

Respondents.

APPENDIX TO PETITION FOR CERTIORARI

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APPENDIX A

United States Court of Appeals

FIFTH CIRCUIT.

No. 80-1145.

DAVID C. MEYERS, *et al.*,
Plaintiffs-Appellees,

v.

SHEARN MOODY, JR.,
Defendant-Appellant,

BERNARD HAINES, *et al.*,
Plaintiffs-Appellees,

v.

SHEARN MOODY, JR.,
Defendant-Appellant,

THARPE FORRESTER,
Receiver-Appellee,

v.

SHEARN MOODY, JR.,
Defendant-Appellant,

(DEC. 23, 1982)

Appeal from the United States District Court for the Northern District of Texas.

Before THORNBERRY, REAVLEY and JOHNSON, Circuit Judges.

The receiver ("Receiver") of Empire Life Insurance Company of America ("Empire") brought this action against Empire's president, board chairman and majority

shareholder, Shearn Moody, Jr. ("Moody"), alleging that Moody violated both federal securities law and his fiduciary duties in the management of Empire's affairs. The jury verdict and district court judgment, 475 F.Supp. 232 (D.C. Ala. 1973), went against Moody on both securities and common law grounds. Moody appeals and we affirm.

In the summer of 1963 Empire was a fledgling company licensed in a single state, with no business, one employee, $256,000 of capital and surplus and no other assets. By the end of 1968 Empire was licensed in sixteen states, with approximately $455,000,000 of business in force, 500 full-time agents, $20,000,000 in reported surplus and $60,000,000 in reported assets. This phenomenal growth was made possible by Moody's assignment to Empire of 40 percent of his life estate in a trust established by his grandmother.[1] The life interest was admitted as an asset of Empire at a value of $5,813,440 in 1964, $14,403,200 in 1965, and $4,250,000 in 1972. When the life interest's assigned value increased, Empire prospered; when its value declined, Empire collapsed.

[1] A critical factual issue has been the designation of responsibility for the $14,403,200 value placed on the life interest. Moody claimed that responsibility rested with national accounting firms, an independent actuary and the Alabama Superintendent of Insurance. The jury found that the value increase was done by Moody as part of a scheme to defraud. As will be seen, that finding is supported by the evidence. Other facts and legal issues, however, must be faced to dispose of the appeal.

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[1] This 40 percent of Moody's life estate in his grandmother's trust will hereafter be referred to as "the life interest."

I.

FACTUAL BACKGROUND: THE RISE AND FALL OF EMPIRE[2]

In 1943 the Libbie Shearn Moody Trust was created for the benefit of certain heirs, including Shearn Moody, Jr. The corpus of the trust consisted chiefly of 9,949,585 shares of stock in American National Insurance Company ("ANICO"), and ANICO dividends produced approximately 90% of the trust's income. Moody inherited a one-eighth life interest in this trust.

On June 27, 1963, Moody incorporated Empire Life Insurance Company in the State of Alabama. Moody, the company's sole shareholder, contributed $256,061 to Empire. Such meager capital could not support Moody's ambitious plan — to amass quickly as many assets as possible by acquiring other life insurance companies, which are required by law to have substantial assets in reserve to pay policyholder claims. To embark upon an acquisition program Empire needed a substantial surplus.

Empire acquired that surplus in July 1963 when Moody assigned to it 40 percent of his interest in the Libbie Shearn Moody Trust in consideration for a $200,000 surplus debenture. Moody and Dale R. Major, Moody's lawyer and chief assistant, intended and believed that the instrument assigning the life interest precluded its further transfer; but Moody never communicated this thought to any insurance commissioner, Empire director, or Empire shareholder, despite (or because of) the fact that an asset which cannot be transferred cannot be admitted as an asset of an insurance company.

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[2] The following synopsis of facts is stated most favorably to the jury verdict, and hence the plaintiff. *See Quinn* v. *Southwest Wood Products, Inc.*, 597 F.2d 1018, 1019 (5th Cir. 1979).

Before the life interest could be used to support Empire's expansion, it was necessary that the Alabama Superintendent of Insurance "admit" the interest as an asset of Empire at an approved value. To determine the interest's value, Moody employed the actuarial firm of Lloyd K. Friedman & Associates and the national accounting firm of Ernst & Ernst. In the spring of 1964 Lloyd Friedman furnished Henry Hogan, a partner in Ernst & Ernst, with a suggested method of calculating the life interest's value. This method took into consideration an actuarial factor (Moody's life expectancy) and three economic factors (current trust income, future increases in trust income, and future interest rates), the objective being to arrive at the present value of predicted income from the trust. Hogan accepted Friedman's valuation method, as well as his assessment of Moody's life expectancy and current trust income. Hogan himself selected what he considered the most reasonable growth rate and discount rate. In determining the applicable growth rate, Hogan noted that ANICO's cash dividends had increased at an average annual rate of nearly 40 percent over the previous twelve years. Hogan expressly took this increase into account in concluding that it would be most reasonable to assume a 5 percent growth rate in trust income. In determining the applicable discount rate to apply to future income, Hogan considered but rejected a 4 percent rate in favor of a 5 percent rate.[3] In a letter dated September 1, 1964, Hogan informed Moody that, based on the valuation method and assumptions set forth above, the life interest owned by Empire should be valued at $5,813,440.

At Moody's request, Lloyd M. Jard, a partner in the accounting firm of Peat, Marwick, Mitchell & Co., ("Peat

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[3] The higher the discount rate, the lower the present value of the life interest.

Marwick") transmitted a copy of Hogan's letter to Walter S. Houseal, Superintendent of Insurance for the State of Alabama. On October 27, 1964, Superintendent Houseal informed Empire that the Alabama Insurance Department accepted the life interest as an admitted asset of Empire at a value of $5,813,440. Houseal stipulated, however, that acceptance of the life interest at this or any other value would continue only so long as the Department received each year an updated appraisal of the life interest "prepared by Ernst & Ernst or other competent appraiser." Empire listed the life interest as an admitted asset at a value of $5,813,440 in its December 31, 1964 report to shareholders.

The $5,813,440 valuation of the life interest provided Empire with the surplus necessary to consummate a merger with Consolidated American Life Insurance Company ("CALICO"), a publicly held corporation. On December 31, 1964, Empire issued 345,103 shares of Class A common stock for all of CALICO's outstanding common stock. Although Empire acquired minority shareholders as a result of this merger, Moody retained virtually all of the company's Class B voting stock, as well as the ability to elect all but one of its directors.

The CALICO merger so depleted Empire's surplus that the rapid expansion program envisioned by Moody was placed in jeopardy. Thus, within six months of Superintendent Houseal's approval of the life interest at a value of $5,813,440, Moody undertook a series of actions that resulted in an increase in excess of $8,000,000 in the life interest's admitted value.

In a letter dated March 8, 1965, Dale Major, who was by now executive vice-president and secretary of Empire, informed Houseal that ANICO had recently announced a dividend increase of two cents per share. Major continued:

> Our accountants have been apprised of the [dividend increase], and have been instructed to prepare immediately a current evaluation based on this increased dividend. As soon as this appraisal is received it will be forwarded to you.

About the same time, Moody asked Lloyd Friedman to recalculate the value of the life interest based on new economic variables. In a letter dated March 31, 1965, Friedman responded by setting forth in summary fashion alternative valuations of Moody's entire one-eighth life estate as of December 31, 1964. Friedman's calculations assumed current annual income of $400,000, a discount rate of 4%, and alternative growth rates of 5%, 7½% and 10%. An assumed growth rate of 5% yielded a $19,488,000 valuation of Moody's entire life estate; a 7½% assumed growth rate yielded a $36,000,000 valuation; and a 10% assumed growth rate yielded a $73,908,000 valuation. Friedman offered no opinion as to which, if any, of these assumed growth rates were reasonable.

Friedman's response did nothing more than apply arithmetic to the obvious fact that the value of the life interest owned by Empire could be substantially increased if the three critical economic assumptions on which Ernst & Ernst had based its appraisal were altered. Specifically, the life interest's value would rise from $5,813,440 to $14,403,200 if the appraiser assumed (a) current annual income of $400,000, rather than $370,000, (b) a growth rate of 7½% rather than 5%, and (c) a discount rate of 4% rather than 5%.

Immediately after receiving Friedman's letter, Moody provided Empire's accountant at Peat Marwick with the new computations. On April 2, 1965, Peat Marwick transmitted to Moody a statement of Empire's assets and liabilities as of December 31, 1964. In an accompanying letter,

the accounting firm stipulated that the financial statement was "prepared without audit or verification by us from data you made available, . . . [including] a computation by an independent actuary of the company's life interests in the Libbie Shearn Moody Trust." The statement listed the life interest as an admitted asset with a value of $14,403,200. Noting the discrepancy between this valuation and the $5,813,440 valuation appearing in Empire's December 31, 1964 report to shareholders, the firm stressed that it had not inspected any report which might underlie the actuary's computations.

At about this time, Moody and Major met with Superintendent Houseal during a convention of the National Association of Insurance Commissioners in Miami. Moody and Major informed Houseal that they intended to seek a revaluation of the life interest, and that studies had been made which indicated the life interest was worth approximately $14,000,000.

On April 8, 1965, Lloyd Jard of Peat Marwick transmitted to Superintendent Houseal, at Moody's request, a copy of Friedman's letter setting forth alternative valuations of the life interest. Houseal apparently also received a copy of Peat Marwick's unaudited financial statement, as well as another copy of Friedman's letter containing the following addendum: "Two-fifths of the trust valuation at $36,008,000.00 is equivalent to the $14,403,200.00 appearing in the Peat, Marwick & [*sic*] Mitchell & Co. financial report dated December 31, 1964."

Major testified that a formal valuation hearing was held in the spring of 1965 before Superintendent Houseal and that Houseal then accepted a $14,403,200 valuation of the

life interest.[4] No written record of either this hearing or its findings was introduced.

Immediately following Houseal's approval of the increased valuation of the life interest, Empire embarked upon an aggressive acquisition program. In the last six months of 1965 the company's size more than doubled. In June, Empire made a stock-for-stock acquisition of the Empire Life Insurance Company of America (Little Rock, Arkansas).[5] In November, the company paid cash for a controlling interest in the National Insurance Company of America. These developments were noted in Empire's December 31, 1965 report to shareholders. The annual report also listed the life interest as an admitted asset at a value of $14,403,200 and stated:

> Valuation of the trust was calculated by the national accounting firm of Ernst & Ernst, and actuaries including Mr. Lloyd K. Friedman, F.S.A., consulting actuary of Houston.

Moody now concedes that this statement was inaccurate and that Ernst & Ernst did not review the 1965 revaluation.

Empire's expansion program continued in 1966 with the stock-for-stock acquisition of National Empire Life Insurance Company. Despite this extraordinary growth, no state undertook to review the company's financial affairs until the fall of 1966. At that time insurance examiners

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4. Evidence was presented at trial that tended to prove that Houseal might have been swayed by considerations of friendship and obligation in approving the increased valuation of the life interest. Major and Houseal were friends; indeed, Major recommended Houseal for the position he accepted after stepping down as Superintendent of Insurance. Moreover, Houseal had visited Moody's Texas ranch on several occasions at Empire's expense.

5. At the time of this merger the words "of America" were added to Empire's name.

for the states of Alabama, Texas and Arkansas reviewed Empire's financial condition as of December 31, 1965. The examiners, apparently non-plussed by the sudden and substantial increase in the value of the life interest between 1964 and 1965, consulted Superintendent Houseal for an opinion. Following a meeting with Houseal in October of 1966, the examiners drafted a report that concluded with this curiously limited certification: "The customary insurance examination procedures . . . have been followed in connection with the verification and evaluation of the *liabilities* shown in the financial statement of this report" (emphasis added).

On the surface, 1968 was a banner year for Empire. The company's assets increased over 50 percent in that year alone, and the number of subsidiaries under Empire's effective control or under common control with Empire expanded from nine to thirty-one. Empire acquired control of Universal American Life Insurance Company in January, Capital Security Life Insurance Company in April, Investors Preferred Life Insurance Company in May, Centennial Reserve Life Insurance Company in June, and National Investor's Life Insurance Company (a complex of twenty-eight companies, including twelve life insurance companies) in August. In addition, Empire entered into reinsurance agreements with Reliance Life & Accident Insurance Company of America in January, Republic Investors Life Insurance Company in April, American Trust Life Insurance Company in June, and Investors Preferred Life Insurance Company in December.

Although Empire touted its rapid expansion program as a sign of the company's robust health, the true effect of the program was to render the company perilously close to collapse. The aggregate impact of the acquisitions was to drain Empire of its liquid assets. Cash might be obtained

so long as the life interest was admitted as a $14,403,200 asset of the company. A significant devaluation of the life interest, however, would end the ride.

In the following year just such a devaluation was threatened. In December 1968, R. Frank Ussery had replaced Walter Houseal as Alabama's Superintendent of Insurance. By then, the insurance commissioners of several states in which Empire did business had become sufficiently doubtful of the value assigned the life interest that they commissioned the American Appraisal Company to conduct a formal appraisal. In February 1969, American Appraisal reported that as of September 30, 1968, the life interest had a value for continued use of $8,600,000 and orderly liquidation value of $4,250,000. At about the same time, examiners for the states of Texas, Arkansas and Alabama issued an unofficial report of examination as of December 31, 1968, assigning the life interest a value of zero.[6]

In response to these reports, Superintendent Ussery ordered Empire to cease writing new insurance policies and to engage in no further acquisitions and mergers. In June 1969, Ussery accepted a proposal made by Moody whereby Empire would gradually diminish the life interest's net asset value from $14,403,200 to an eventual value of zero. (Empire did not, however, devalue the life interest as agreed.) At the same time, a panel composed of Ussery and four other state insurance commissioners was formed to attempt to rehabilitate the company. The panel met with little success: Empire sustained net operating losses of $1,734,700 in 1969 and in 1970 was temporarily forced to delay payments of claims due to lack of cash revenues.

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6. To quell doubts about the $14,403,200 valuation, Moody hired Richard P. Johnson, an economics professor at Southern Methodist University, to undertake a valuation of the life interest. In November 1968, Johnson reported that the life interest's value as of December 31, 1968 would be no lower than $16,000,000, and that a reasonable valuation was $23,000,000.

In January 1971, John G. Bookout replaced Frank Ussery as Alabama's Superintendent of Insurance. Upon learning that no official report of Empire's financial condition had been issued in five years, Bookout ordered that a pending examination be promptly completed. In December 1971, examiners for the states of Alabama, South Dakota and Texas submitted their report of Empire's affairs as of December 31, 1970. The examiners assigned the life interest a value of $4,250,000, in accordance with the fair market valuation by American Appraisal, and found that Empire was statutorily insolvent in excess of $6,000,000 and impaired in excess of $10,000,000.

In April 1972, after reviewing the results of the examination, Superintendent Bookout instituted a receivership proceeding in Alabama court against Empire. Two months later, after a three-week hearing largely devoted to the proper valuation of the life interest, the trial court placed Empire into receivership. The court appointed Superintendent Bookout as receiver and authorized him to solicit offers from other insurance companies for the reinsurance of Empire. At about the same time, the states of Texas, Arkansas and Montana also placed Empire into receivership.

In January 1974, the Alabama receiver sought an order of liquidation of Empire and approval of a bulk reinsurance agreement presented by Protective Life Insurance Company ("Protective"). After another extensive hearing, the receivership court found that Empire was statutorily insolvent in excess of $6,000,000 and impaired in excess of $10,000,000, and that the company's financial condition was "rapidly deteriorating." On June 14, 1974, the court entered an order granting the receiver's petition to liquidate and reinsure the business of Empire into Protective.

In June 1974, Receiver filed a complaint against Moody in United States District Court for the Northern District of Texas[7] alleging that in his management of Empire Moody had violated his fiduciary duties of care and loyalty as well as § 10(b) of the Securities Exchange Act of 1934. The case was tried before a jury in December 1976. In response to special interrogatories, the jury found that Moody had violated both his common law duties to Empire and the federal securities laws. On May 29, 1979, the trial court entered judgment against Moody for actual damages of $5,319,000 and punitive damages of $1,000,000, together with accrued interest. *Meyers* v. *Moody*, 475 F.Supp. 232 (N.D.Tex. 1979). This is an appeal from that judgment.

II.

THE LEGAL ISSUES

A. *Preliminary Matters*

1. *Standing*

Moody first complains that plaintiff Receiver, appointed under the laws of Alabama, lacked standing to bring suit in a court outside the state of his appointment.

[2] The capacity of a receiver to sue in federal court is governed by the law of the forum state. Fed.R.Civ.P. 17(b); Wright & Miller, Federal Practice and Procedure § 1567 (1971). The controlling case in Texas is *Carpenter* v. *Pink*, 133 Tex. 82, 124 S.W.2d 981 (1939). In that case a New York court placed an insolvent New York corporation in the hands of the New York Insurance Commissioner.

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7. On March 21 and May 5, 1972, Empire shareholders had filed derivative suits against Moody. These suits were subsequently consolidated. Receiver joined in the consolidated derivative action as plaintiff, and the shareholders' derivative action was abated and ultimately dismissed, leaving only Receiver's derivative action.

At the Commissioner's request a Texas ancillary receiver was appointed to preserve the company's assets in Texas. In a subsequent suit brought in Texas court, the Texas receiver disputed the New York Commissioner's authority under Texas law to prosecute an appeal. The Supreme Court of Texas held that the Commissioner was entitled to prosecute the appeal because he was lawfully a party to the suit in the court below. The court stated:

> We are aware of the general rule that an administrator appointed in one state cannot sue in another, and an ordinary equity receiver appointed by a State court has no extraterritorial powers, but such rule cannot be applied here.... [T]he New York receiver ... did not derive his powers, authority, and title from the decrees of the appointive court, but from the laws of the state which created or chartered this corporation.... [S]ince the State of New York created this corporation, it had the lawful right to say, by statute, who [the corporation's] agents should be ..., both while this corporation was a solvent and going concern, and after it had been declared insolvent.... For us to refuse to recognize the New York Insurance Commissioner as a party to this suit under the facts of this record would be to deny full faith and credit to the statutes and judicial decrees of the State of New York.

Id. 124 S.W.2d at 987 (citations omitted).

[3] Since Empire Life Insurance Company was created by the laws of Alabama, Alabama had the right to designate its agent in insolvency. The receiver in this case, like the receiver in *Carpenter,* derived his authority not from the decrees of the appointive court but from the laws of the appointive state. Alabama Code § 27-32-15 provides in pertinent part:

> As a domicilary receiver, the commissioner shall be vested by operation of law with the title to all of the property, contracts and rights of action . . . wherever

> located, as of the date of entry of the order directing him to rehabilitate or liquidate a domestic insurer . . . .

The Alabama receiver accordingly had standing to bring suit in United States District Court for the Northern District of Texas.

[4] Moody also argues that Receiver did not have standing to sue on behalf of Empire's shareholders, policyholders or creditors. The law in Texas is to the contrary. In *Cotten* v. *Republic National Bank of Dallas*, 395 S.W.2d 930 (Tex.Civ.App.—Dallas 1965, writ ref'd n.r.e.), the court stated:

> Certainly a receiver for an insolvent insurance corporation . . . has a right to maintain a suit which is necessary to preserve the corporation's assets and to recover assets of which the corporation has been wrongfully deprived through fraud. In such a suit the receiver may be said to sue as the representative of the corporation and its creditors, stockholders and policyholders. . . .

Id. at 941. Moody's challenges to plaintiff's standing are without merit.

2. *Statute of Limitations*

The events which form the basis of Receiver's state and federal claims occurred more than three years before this suit was commenced. The increased valuation of the life interest occurred in 1965; the acquisition program which that valuation made possible was concluded in December 1968; and the present action was brought in March 1972. Moody argues that Receiver's suit is accordingly barred by applicable statutes of limitations.[8]

[5] State law determines when a state law cause of action accrues, *see Walko Corp.* v. *Burger Chef Systems*,

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[8] Receiver's state law claims are governed by a two-year limitations period. *See* Tex.Rev.Civ.Stat.Ann. art. 5526(4) (repealed

Inc., 554 F.2d 1165, 1171 (D.C. Cir. 1977). Under state law, a cause of action based on fraud accrues only when the fraud is discovered or by the exercise of reasonable diligence should have been discovered. *Gaddis* v. *Smith*, 417 S.W.2d 577 (Tex. 1967). Whether a plaintiff has exercised the degree of diligence necessary to toll the statute of limitations is a question of fact. *Cotten* v. *Republic National Bank of Dallas*, *supra*, at 946; *L.C.L. Theatres* v. *Columbia Pictures Industries, Inc.*, 566 F.2d 494, 497 (5th Cir. 1978).

Moody argues that all causes of action in the present case accrued upon the conclusion of Empire's acquisition program in 1968, because by that time Empire's disinterested shareholders and directors and the various insurance commissioners involved had knowledge of facts from which they could have inferred the existence of any common law violations. The jury, however, found in response to special interrogatories that Moody concealed material facts from all these persons, and that reasonable diligence would not have alerted them to Moody's wrongful acts before March 1971.

[6] The jury's findings are supported by the evidence. Empire's shareholders were explicitly informed in Empire's 1965 annual report that the $14,403,200 valuation of the life interest was calculated by Ernst & Ernst and by actuaries including Lloyd Friedman; every subsequent report to shareholders until 1972 continued to assign the life interest a $14,403,200 value.[9] Three of Empire's directors, Hilton

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effective August 27, 1979); *White* v. *Bond*, 362 S.W.2d 295 (Tex. 1962). In light of our disposition of the 10b-5 issue, *see* section (II)(B)(2), *infra*, we need not decide the applicable limitations period for that claim and whether it was tolled.

9. Absent cause to question them, it is reasonable for shareholders to rely on the knowledge and integrity of the corporate managers with respect to shareholder reports. *De Haas* v. *Empire Petroleum Co.*, 435 F.2d 1223, 1227 (10th Cir. 1970).

Painter, Frank Schmidt and Richard Linn, testified at trial that they were led to believe the increased valuation was based upon an appraisal by an accounting or actuarial firm. R. Frank Ussery, Alabama's Superintendent of Insurance from December 1968 to January 1971, testified that he, too, believed the increased valuation was based on assumptions provided by an accounting or actuarial firm. The jury could reasonably have found that the reliance of these persons on Moody's representations was justified, and that their diligence was sufficient to toll the statute of limitations.

3. *Equitable Estoppel*

In April 1975, three years after the present action against Moody was initiated, Receiver entered into an agreement to effectuate a bulk reinsurance treaty with Protective Life Insurance Company of America ("Protective"). Under this treaty Protective acquired virtually all of Empire's assets and liabilities. Receiver retained Empire's right of action against Moody, but agreed to pass along to Protective any recovery obtained from Moody. Since Empire's liabilities exceeded its assets, Protective stipulated that it would reinsure only those Empire policyholders who accepted a ten-year moratorium on the right to receive the cash values of their policies. Protective and Receiver agreed that any recovery against Moody would inure to the benefit of those policyholders by reducing the moratorium amount established under the treaty.

Moody contends that Protective is the real plaintiff in interest under these facts, and that any recovery against Moody would unjustly enrich Protective in violation of the equitable principles enunciated in *Bangor Punta Operations, Inc.* v. *Bangor & Aroostook Railroad,* 417 U.S. 703, 94

S.Ct. 2578, 41 L.Ed.2d 418 (1974). In *Bangor Punta* the Amoskeag Company ("Amoskeag") purchased virtually all the stock of the Bangor & Aroostook Railroad ("BAR"). BAR subsequently sued its former owner for corporate waste and mismanagement. The Supreme Court held that equity precluded BAR from maintaining the action, reasoning that although the suit was purportedly brought on BAR's behalf, the real party in interest and the principal beneficiary of any recovery was Amoskeag. Since the depressed price Amoskeag had paid for BAR's stock already reflected the effects of the earlier mismanagement, any recovery would constitute a "windfall" for Amoskeag.

Bangor Punta is distinguishable from the present case in several respects.

First, Protective in this case, unlike Amoskeag in *Bangor Punta,* cannot fairly be considered the principal beneficiary of any recovery against the injured corporation's former owner. Although Protective might benefit derivatively from such recovery, the principal beneficiaries under the express terms of the reinsurance agreement are the policyholders of Empire. These policyholders are Empire's creditors, and have suffered direct injury as a result of Moody's improprieties. By contrast, the Supreme Court in *Bangor Punta* stressed that Amoskeag was not suing on behalf of the injured corporation's creditors, 417 U.S. at 718 n. 15, 94 S.Ct. at 2587 n. 15, and had not itself suffered any injury, 417 U.S. at 711-12, 94 S.Ct. at 2583-84.

Second, even if Protective were the principal beneficiary of any recovery in this case, it still could not fairly be considered the beneficiary of a "windfall." The Supreme Court's finding in *Bangor Punta* that any recovery against BAR's former owner would constitute a windfall for Amoskeag turned on the fact that Amoskeag received all it had bargained for when it acquired BAR's

stock. In the present case, however, Protective did *not* receive all it had bargained for when it acquired Empire's assets since it had sought and obtained an agreement that any recovery against Moody would be applied to reduce the policyholder's moratorium. Far from being an unexpected gain, a recovery against Moody was clearly contemplated by Protective and provided for in its reinsurance agreement with Receiver.

[7] Finally, in *Bangor Punta* there was no lawsuit, and there could have been no lawsuit, until Amoskeag acquired BAR's stock. By contrast, Empire initiated this action against Moody several years before Protective acquired Empire's assets. Moody is thus urging us to *extinguish* a cause of action that both existed and was pursued long before the transfer of Empire's assets took place. Neither law nor equity permits us to do so. Empire suffered a cognizable injury for which a remedy exists. To hold that the remedy abates because the corporation's assets were sold would result in inequity that the Court in *Bangor Punta* sought to avoid, and would make Moody himself the beneficiary of a windfall. *See National Union Electric Corporation* v. *Matsushita Electric Industrial Co.*, 498 F.Supp. 991, 1003 (E.D.Pa.1980). Receiver is not equitably estopped from bringing this action under the principles enunciated in *Bangor Punta*.[10]

[8-10] Moody also argues that Receiver is equitably estopped from bringing this action because Moody

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[10] It bears noting as well that *Bangor Punta* involved a transfer of stock rather than assets. Moody cites no case, and we have found none, in which *Bangor Punta* is applied to preclude recovery by a plaintiff who has acquired a corporation's assets rather than its stock. This is hardly surprising, since the transferee of a corporation's assets has no right of action against the corporation's prior owners for mismanagement unless the transfer agreement gives it such a right – in which case any recovery would not constitute a "windfall."

increased the value of the life interest and pursued the subsequent acquisition program in reliance on the approval issued by Empire's shareholders and board of directors and the Alabama Department of Insurance. The sole virtue of this contention is audacity. The doctrine of estoppel is for the protection of innocent persons, and only the innocent may invoke it. A party may not invoke an estoppel for the purpose of shielding himself from the results of his own fraud, dereliction of duty, or other inequitable conduct. *El Paso National Bank* v. *Southwest Numismatic Investment Group, Ltd.*, 548 S.W.2d 942, 949 (Tex. Civ. App. — El Paso 1977, no writ). Moreover, a party invoking estoppel must be ignorant of the facts which the party to be estopped is alleged to have represented by his conduct or silence. *Investors Realty Trust* v. *Carlton Corp.*, 541 S.W.2d 289, 292 (Tex. Civ. App. — Dallas 1976, no writ); *Clifton* v. *Ogle*, 526 S.W.2d 596, 603 (Tex. Civ. App. — Fort Worth 1975, writ ref'd n.r.e.). Moody is in no position to invoke an estoppel against Receiver.

B. *Liability*

1. *Common Law*

a. *Applicable Law*

[11] A threshold issue concerns the law to be applied in determining the nature and extent of Moody's fiduciary obligations to Empire. We apply the conflict of law principles of Texas (the forum state) in resolving this issue. *Klaxon Co.* v. *Stentor Electric Manufacturing Co.*, 313 U.S. 487, 61 S.Ct. 1020, 85 L.Ed. 1477 (1941). Specifically, we look to the Texas Business Corporation Act (the "Act"), which was enacted in 1955 and in force at all times relevant to this lawsuit.

[12] Tex.Bus.Corp.Act Ann. art. 9.14(A) (Vernon) provides that the Act does not apply to foreign corporations which are granted authority to transact business within

the state under any special statute, except that, where the special statute contains no provision regarding matters provided for in the Act with respect to foreign corporations, the Act applies to the extent it is not inconsistent with the special statute. Insurance companies are among those foreign corporations authorized to transact business in Texas under a special statute. *See* Tex.Ins.Code Ann. art. 3.57, 21.43 (Vernon). The Texas Insurance Code nowhere specifies the duties or liabilities of officers or directors of insurance companies. The Texas Business Corporation Act, on the other hand, provides that officers and directors of a foreign corporation doing business in the state are subject to the same duties and liabilities as are imposed upon officers and directors of domestic corporations. Tex. Bus.Corp.Act Ann. art. 8.01, 8.02; *see* Model Business Corporation Act § 99 par. 1 ¶ 2.02(3) (1960). Nothing in the Texas Insurance Code is inconsistent with this provision. We conclude that Moody was subject to the same duties and liabilities that Texas law imposes upon officers and directors of Texas corporations.

b. *Breach of Duty of Care*

[13, 14] Texas law imposes on corporate officers and directors a duty to exercise due care in the management of the corporation's affairs. If they breach that duty, they are liable to the corporation for any loss it may suffer as a result of their neglect. *See Sutton* v. *Reagan & Gee,* 405 S.W.2d 828, 834 (Tex.Civ.App.—San Antonio 1966, writ ref'd n.r.e.); *Fagan* v. *La Gloria Oil & Gas Co.,* 494 S.W.2d 624, 628 (Tex.Civ.App.—Houston [14th Dist.] 1973, no writ). "Due care" is that degree of care which a person of ordinary prudence would exercise under the same or similar circumstances.

The jury found in response to special interrogatories that Moody negligently managed Empire's business affairs and

breached his fiduciary duties to the company. The jury also found that Moody's behavior amounted to "intentional misconduct or gross negligence." The jury thus accepted Receiver's contention that Moody was at least grossly negligent in undertaking a massive acquisition program based on an artificial surplus created by the $14,403,200 revaluation of the life interest.

Moody here asserts that both the revaluation of the life interest and the subsequent acquisition program involved legitimate exercises of business judgment. Moody first contends that his revaluation of the life interest was reasonable since it was based on appraisals made by accountants and/or an actuary. The evidence is to the contrary. Hogan of Ernst & Ernst and Jard of Peat Marwick both testified that they did not revalue the life interest; indeed, Hogan stated he did not learn of the revaluation until the time of trial. He testified that the trial was the first occasion that Ernst & Ernst even had knowledge that its name had been used in Empire's 1965 annual report with the false statement that the $14 million valuation of the life interest had been calculated by his firm. Lloyd Friedman, the actuary who Moody now claims was chiefly responsible for the revaluation, testified that he did nothing more than determine Moody's life expectancy and make mathematical calculations based upon economic assumptions provided by Moody. Moody rebutted none of this testimony, and all of it is fully corroborated in the record. The conclusion is inescapable that the $14,403,200 value was placed on the life interest by Moody himself.

[15] Moody next contends that, whether or not outside experts were responsible for the revaluation, $14,403,200 was a reasonable value to place on the life interest. In particular, he argues that it was reasonable to raise the life interest's assumed growth rate from 5% to 7½% (thereby

boosting the life interest's value by millions of dollars) because ANICO's dividends, which constituted virtually all of the life interest's income, had enjoyed a 19% average annual growth rate between 1944 and 1964. This argument is easily met by noting that Ernst & Ernst was familiar with ANICO's earnings record when it found an assumed growth rate of 5% to be most reasonable. Moreover, ANICO's subsequent earnings history vindicated Ernst & Ernst's conservatism: between 1964 and 1974, the years here at issue, ANICO's dividends increased at an annual rate of only 4.62%. Finally, the $14,403,200 valuation was clearly unreasonable in relation to the life interest's income; between 1966 and 1970 the highest annual yield on the life interest at the $14 million valuation was 1.52%. Thus, between 1966 and 1970 the average amount of income that the life interest actually brought Empire each year was only about $200,000, an amount grossly disproportionate to its valuation. One expert testified that life insurance companies during those years generally guaranteed their policyholders a return of between 2½% and 3% on ordinary life insurance policies, and that the minimum yield on an asset required to guarantee such a return prudently was 3½%.[11]

Even if Moody's $14,403,200 valuation of the life interest had been reasonable, his subsequent course of conduct was not. Moody had reason to know that the life interest's value was extraordinarily volatile having seen it leap from $5,813,440 to $14,403,200 within a space of six months.

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11. Moody also contends that, even if the $14,403,200 revaluation of the life interest were unreasonable, he is not responsible for Empire's subsequent losses because the Alabama Insurance Commisioner approved the revaluation. This contention is spurious. An insurance company may not delegate responsibility for valuation of its assets to a state agency, and the mere fact that an insurance commissioner accepts a company's asset valuation does not immunize the company from liability arising from that valuation.

Moody also knew, or should have known, that if he expended Empire's liquid assets in an acquisition program any significant decline in the life interest's value would instantly render Empire insolvent. Moody nevertheless embarked upon a massive acquisition program that drained Empire of its liquid assets and made the company's economic survival depend entirely on the stability of the life interest's value. The jury could reasonably find that Moody was grossly negligent in failing to provide for the contingency that in 1972 became a reality—a sudden and substantial decline in the life interest's value.

[16] The jury's finding that Moody was grossly negligent in his management of Empire is supported by the testimony of numerous witnesses at trial. Hilton Painter, who served Empire for ten months as vice-president and director, testified that Moody was "totally incapable of operating a life insurance company," and ran Empire in an illogical, irresponsible and dangerous manner.[12] Frank Schmidt,

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12. The testimony of several witnesses at trial supports the conclusion that Moody often exhibited a blatant, callous disregard for the interests of Empire's shareholders and policyholders, especially when their interests conflicted with his own ambitious plans for the company. For instance, the following excerpt from Mr. Painter's testimony highlights one such incident that occurred during a meeting of Empire's executive committee of directors and officers:

[Mr. Hilton]:

A question arose concerning the expenditure of certain funds to acquire a minority position in another life insurance company and, as often happens in a meeting like that, there is some discussion about where the money comes from.

Q. (By Mr. Wright) Was Mr. Moody there?

A. Mr. Moody was chairing the meeting, yes sir.

Q. All right, what happened?

A. And I made the comment to Mr. Moody that – that such an expenditure would not be an acceptable expenditure be-

also an Empire vice-president and director, testified that Moody's aggressive acquisition program ran the company into bankruptcy. Laurence Cottingham, an attorney in Empire's legal department, stated that Moody "violated all rules of good management." Thomas Pennington, a vice-president of Protective, testified that Empire's investments were poor to atrocious with limited exception, that policy records were poorly maintained and incomplete, that documentation on policies assumed from acquisitions was virtually non-existent, that the administration of the reinsurance program indicated gross negligence, and that Empire was "probably the worst managed company" he

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cause it constituted the use and, in my opinion, the unauthorized use of policyholder reserves.

Q. What was Mr. Moody's reply?

A. (No response).

Q. Precisely?

A. Mr. Moody was standing at the end of the table –

THE COURT:

What was his reply?

THE WITNESS:

His reply was, "F(_ _)k the policyholders."

Q. (By Mr. Wright) All right, Mr. Painter, I take it you've heard that word used before in your adult life?

A. Yes.

Q. I want to ask you this: Have you ever heard the use of that particular profanity in a jocular manner?

A. Yes.

Q. Heard it simply used as an adjective to highlight something?

THE COURT:

Just ask him.

Q. How do you interpret that that phrase was meant at that time?

A. He said it without a trace of smile and it was very clear that he meant it in the crudest and most malicious way.

had ever seen. The jury's finding of gross negligence on the part of Moody is amply supported by the evidence.

[17, 18] Moody also argues that the district court erred in its instructions to the jury regarding the law applicable to directors' duty of care. First, he challenges the court's instruction that he was to be "held to a higher standard of care and fair-dealing than would be one not in a fiduciary position." This instruction is however, patently correct. See 15 Tex. Jur.3d, "Corporations," § 235 (1981); H. Henn, *Law of Corporations* §§ 234, 235 (2d. ed. 1970). Second, Moody complains that the court failed to instruct the jury regarding the applicability of the business judgment rule. This complaint, too, is fatuous: the court explicitly instructed the jury that directors "are not held responsible for ordinary mistakes of business judgment," and that "if Moody exercised reasonable business judgment in the acquisition program and perpetrated no fraud he is not liable to the receiver in this case however mistaken his actions might appear to be in hindsight." *See Conrick* v. *Houston Civic Opera Ass'n,* 99 S.W.2d 382, 384 (Tex.Civ. App. — Amarillo 1936, no writ); Henn, *Corporations* at § 242. Finally, Moody asserts that the court erred in instructing the jury that Moody owed fiduciary duties to the policyholders of Empire, as well as its stockholders and the corporate entity itself. We are not certain that this instruction was erroneous. *See, e.g., American Trust Co.* v. *California Western States Life Insurance Co.,* 15 Cal.2d 42, 98 P.2d 497, 510 (1940); 18 J. Appleman, *Insurance Law and Practice* § 10012 (1945). Even if this instruction were erroneous, the error was harmless.

2. *Securities Law Claims*

The jury in this case found that Moody had engaged in conduct in violation of Securities Exchange Commission

Rule 10b-5, 17 C.F.R. § 240.10b-5 (1981), enacted pursuant to § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1976). Specifically, the jury found that Moody (1) failed to disclose his belief that the trust interest was intended to be non-transferable by Empire, and (2) fraudulently misrepresented the value of the life interest. Moody raises a variety of arguments in this appeal contesting the jury's findings of liability under Rule 10b-5. We need not decide, however, whether the jury's findings and the district court's holding of liability under this ground were correct, because the damages awarded may be sustained on the basis of the common law claims.

At the close of trial, the court submitted 17 special interrogatories to the jury. Question 1 asked whether Moody was negligent in his management of Empire; Question 2 asked whether Moody breached his fiduciary duties to Empire; Question 3 asked whether such negligence or breach of fiduciary duties constituted intentional misconduct or gross negligence; Question 4 asked whether Moody breached his fiduciary duties in connection with the guarantee of Credit Factoring's indebtedness to Moody Bank; Question 5 asked whether such negligent mismanagement or breach of fiduciary duties proximately caused damage to Empire stockholders' capital and surplus or Empire's ability to meet its policyholders' obligations; and Questions 6-9 cumulatively asked whether Moody violated the securities laws. The jury answered all these questions affirmatively. Question 10 then stated:

> Find from a preponderance of the evidence, what sum of money, if any, if paid now in cash would fairly and reasonably compensate Empire for damages cause [sic] by the depletion, if any, of its stockholders' capital and surplus proximately caused by such negligent mismanagement, breach of fiduciary duties or securities violations as you may have found.

The jury answered: "five million dollars."

[19] Moody argues that it is impossible to determine whether the jury based its assessment of $5,000,000 compensatory damages on the allegedly improper securities law theory or on the common law theory, and that the case must therefore be remanded for a new trial. This contention fails for several reasons. First, it is clear from the jury's answers to Questions 1-5 that it found Moody liable under common law independent from and without reference to his liability under Rule 10b-5. Second, although Question 10 is phrased in the disjunctive, the *measure* of damages recoverable by Receiver under Texas common law is the same (as will be demonstrated below) as it is under Rule 10b-5. Furthermore, there was only one wrong complained of and proved: the manipulation of the life interest leading to fatal undercapitalized acquisition; and the proof of damages on the depletion of capital was the same and not linked only to one theory of liability. Thus, the $5 million figure assessed by the jury may stand irrespective of Rule 10-b liability.[13]

C. *Damages*

1. *Measure of Damages*

[20] The district court makes the following statement in its opinion:

> What is not clear is how to measure the loss to Empire. Neither Texas law nor federal securities law provides

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13. Moody cites *Dougherty* v. *Continental Oil Co.*, 579 F.2d 954, 960 n. 2 (5th Cir.1978), *vacated*, 591 F.2d 1206 (5th Cir.1979) in support of his argument. That case is inapposite, however, because the ambiguity there concerned not the theory on which damages were based but the theory on which liability was based. Here it is clear that the jury found liability under *both* theories. Their answers to Questions 1-5 clearly indicate a finding of liability under common law and their answers to Questions 6-9 clearly indicates a finding of liability under federal securities laws. In this case it is irrevelant upon which theory the jury based its finding of damages in Question 10 because, as discussed in text, the measure of damages is the same under either theory.

> a clear guideline, so this court must fashion a measure of damages which comports with the sparse precedent available and which is just. *See Spiegel* v. *Beacon Participations,* 297 Mass. 398, 8 N.E.2d 895, 909 (1937). There being no indication otherwise, the court presumes that the measure of damages for Receiver's common law and securities law claims does not differ under state and federal law. *Cf. Pappas* v. *Moss,* 303 F.Supp. 1257, 1281 (D.N.J.1969).

475 F.Supp. at 237. We believe that the district court's "presumption" on the measure of damages was correct. To understand this conclusion, it is necessary to examine briefly the types of damages available under Rule 10b-5 and common law.

First, it is well-settled that Rule 10b-5 allows recovery of both general and special (or consequential) damages. 5B A. Jacobs, *The Impact of Rule 10b-5* § 260.03[b] (rev. ed. 1980). Special damages are defined as outlays attributable to the defendant's wrongful conduct. *Id.* at § 260.03[d]. Two limits exist on the recovery of special damages: (1) they cannot be awarded if their relationship to the defendant is too remote; (2) they are unavailable if they redress the same injury for which the plaintiff is compensated by general damages or prejudgment interest. *Id.* It is significant to note, however, that special or consequential damages are recoverable even if the plaintiff can show no general damages. *Id.*

[21, 22] Likewise, Texas common law recognizes and allows both general and special damages as a recovery for acts of fraud or deceit. Although we have found no Texas cases specifically addressing the common law liability of a director/president/majority stockholder who violates his fiduciary duties through mismanagement and thereby forces the corporation into insolvency, we determine that Texas law allows special damages against Moody under the

facts here. Examining Texas cases in three factual situations reported upon by the state courts is instructive. Specifically, we look to cases involving: (1) directors who cause the financial condition of the corporation to be misstated, thereby inducing creditors to loan money to the company; (2) the common law actions of fraud and deceit, and types of damages recoverable thereunder; and, (3) negligent corporate mismanagement by directors.

As to the first category, it appears that the Texas courts have long permitted third-party creditors to recover damages personally against corporate directors who fraudulently or even negligently misrepresent the financial condition of the company. Tex Jur.3d summarizes Texas law in this fashion:

> Directors of a corporation are personally liable to anyone who sustains loss by reason of false financial statements made by them. For example, directors have been held personally liable at common law for inducing deposits in a failing bank by representations of its solvency. Of course, the officers are liable if the false statements are shown to have been fraudulently or designedly made. So, also, where an officer has been concerned in the publication of false statements, he is liable for those statements even though he was in fact ignorant of their truth and falsity; it is his duty to inform himself of the true financial position of the corporation.
>
> Directors, in particular, are in a position of special responsibility, in view of the statutory provision vesting in them the general management of the affairs of the corporation. Directors are accordingly held liable, as a matter of law, where it appears that they allowed false statements to be published and used by employees in order to obtain credit for the corporation.

15 Tex.Jur.3d, Corporations § 300 at 455-56 (1981) (footnotes and case citations omitted).

The seminal Texas case illustrating this rule is *Cameron* v. *First National Bank*, 194 S.W. 469 (Tex.Civ.App. — Galveston 1917, writ ref'd), a case in which the plaintiffs extended a line of credit to a manufacturing corporation in reliance on false and fraudulent statements of the company's financial condition as contained in the annual report. The court found that the defendant/directors "knew the method by which the accounts of the mill were kept, and that it has been the uniform custom in preparing financial statements to include in such statements as assets accounts which had proven uncollectable and which by general commercial custom and usage should not be included in a financial statement as assets." *Id.* at 476. Concluding that the directors' authorization of the issuance of such financial statements constituted failure to exercise ordinary care, the court held that "having accepted the position and exercised the duties of directors, and having sanctioned the long-continued method of borrowing money for the company on the faith of yearly financial statements, appellants must be held responsible for the truth of the statements so sanctioned by them." *Id.* *See Durham* v. *Wichita Mill & Elevator Co.*, 202 S.W. 138 (Tex.Civ.App. — Fort Worth 1918, writ ref'd) (similar facts; holding directors liable for fraud and negligence even though plaintiff/creditor did not extend credit wholly in reliance upon false financial statements of corporation); *see also Parsons* v. *Johnson*, 28 App.Div. 1, 5, 50 N.Y.S. 780, 782 (1898) ("[A]n officer of a corporation making a false statement in the annual report becomes liable to the damages which naturally flow from or are caused by the falsehood. The Legislature has not undertaken to define the precise damage which the injured party may recover, but has used a broad term which covers all damages which flow directly from the false statement.").

[23, 24] The above cases dealing with the liability of directors to corporate creditors for false financial state-

ments are grounded upon common law theories of negligence or fraud, or both.[14] Although the common law of fraud is generally more stringent in its requirements than the elements of Rule 10b-5, it is clear that the two are closely related. In Texas in an action for common law fraud or deceit, a plaintiff must allege and prove: (1) an untrue representation made by the defendant (2) known by him to be false (3) concerning a material fact (4) made with the intent to receive the plaintiff and (5) to induce him to act in a particular manner, (6) such representation being one on which the plaintiff relied and (7) which proximately caused his damages, (8) with issues on proximate cause having to be submitted to the jury where "special" damages are sought. *See Success Motivation Institute, Inc.* v. *Lawlis,* 503 S.W.2d 864, 868 (Tex.Civ.App. — Houston [1st Dist.] 1973, writ ref'd n.r.e.); *El Paso Development Co.* v. *Ravel,* 339 S.W.2d 360, 367 (Tex.Civ.App. — El Paso 1960, writ ref'd n.r.e.). Thus *all* of the requirements of a Rule 10b-5 cause of action are included within the elements of fraud under Texas law, which imposes a few additional requirements. *Cf. Huddleston* v. *Herman & MacLean,* 640 F.2d 534, 543 (5th Cir. 1981), *modified,* 650 F.2d 815, *cert. granted,* — U.S. —, 102 S.Ct. 1766, 72 L.Ed.2d 173 (1982).

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14. We emphasize that we do not here decide the liability of a director for false financial statements when such director is ignorant of the facts underlying the misrepresentation. In *Sugarland Industries* v. *Parker,* 293 S.W. 609, 612 (Tex.Civ.App. — Texarkana 1927, writ dismissed), the court noted that "if in the transaction which is in suit it is affirmatively shown that any individual director did not have actual participation or knowledge, a claim of fraudulent or false representation cannot be predicated against him. A director is liable only for his own acts or omissions. He is not merely by virtue of his position liable." In the instant case, Moody's fraudulent and/or negligent misrepresentation of the financial state of Empire is established by the evidence, and he is the only director/defendant before us. As to the liability of a director ignorant of the facts, we are not now called upon to decide that question, but note in passing that we agree generally with the court's position in *Sugarland.*

[25, 26] Moreover, in Texas a defrauded plaintiff may recover both general and special damages, with these terms having approximately the same meaning as they do when one is talking about Rule 10b-5. The difference between general and special damages under Texas law is that general damages are the necessary and usual result of the wrong complained of, while special damages need not be the necessary and usual result of the wrong, but must be the proximate result thereof. *El Paso Development*, 339 S.W.2d at 363. "Special damages, predicated upon a wrong, which are not necessarily the usual result of the wrong, but are directly traceable to the wrongful act complained of and result therefrom, may be recovered in a common law action based on fraud and deceit; but all other damages will be held to be too remote." *Id.* at 363-64. Thus, Texas law limits special damages to those which are not too remote, uncertain, conjectural, speculative or contingent. *Id.* at 364.

The third and final category of Texas cases that is relevant is that addressing the liability of directors or officers for *negligent* (i.e., nonfraudulent) mismanagement of a corporation. For example, in *Sutton* v. *Reagan & Gee*, 405 S.W.2d 828 (Tex.Civ.App. — San Antonio 1966, writ ref'd n.r.e.), the court entertained a mismanagement action filed by a creditor of a bankrupt corporation against its officers. Although the court held that such a suit was not maintainable by an individual creditor of the corporation, it acknowledged such a cause of action is enforceable by the receiver or trustee in bankruptcy of the corporation. *Id.* at 834. With regard to the measure of liability, the court stated that a director owes a duty to the corporation to exercise due care in the management of the corporation's affairs, and for breach of this duty, the director is "clearly liable to the corporation for any loss it may suffer as a result of his neglect." The words "any loss" suggest that

special or consequential damages are recoverable in an action brought for negligent corporate mismanagement against the director of a corporation; *accord, Fagan* v. *La Gloria Oil & Gas Company,* 494 S.W.2d 624, 628 (Tex.Civ. App. — Houston [14th Dist.] 1973, no writ).

[27, 28] From the preceding discussion it is clear that Texas common law:

(1) holds directors liable to third-party creditors who act in partial reliance upon false financial statements that appear in the annual report of a corporation by the authorization of the directors.

(2) on fraud includes *all* of the elements of a Rule 10b-5 cause of action, and permits general and special damages to be recovered.

(3) holds directors who negligently mismanage a corporation liable for "any loss it may suffer as a result."

Finally, it is also clear that both federal and state courts, in awarding damages for violation of Rule 10b-5, have not insisted that the amount of damages be proven with mathematical certainty. Courts have routinely placed upon the defendant the risk of imprecise calculations of damages:

> Although the plaintiff must present as much proof as he can, the defendant has no ground to complain if the plaintiff cannot prove the extent of his injury (as distinguished from the fact he was harmed) with mathematical certainty. In effect, the defendant bears the uncertainty as to the amount of damages.

Jacobs, § 260.02 (footnotes and case citations omitted). Thus, given the obvious parallels betwen the Texas common law action for fraud and Rule 10b-5's elements, and the fact that both recognize and similarly define general and special damages, we conclude that the district court was correct in presuming that the measure of damages for

Receiver's common law and securities law claims does not differ under state and federal law.

2. *Proof of Damages*

[29] Once we accept the premise that the measure of damages are the same under federal or state law, the sole remaining question is whether Receiver adequately proved the *amount* of damages, *i.e.*, whether the evidence at trial supported the jury's verdict.[15] As we examine the evidence, we keep in mind the principle, already stated, that Moody should bear any uncertainty as to proof of the amount of damages and that Receiver need not demonstrate the amount with mathematical certainty.

As recounted earlier, the jury in response to special interrogatories found that $5 million would "fairly and reasonably compensate Empire for damages caus[ed] by the depletion ... of its stockholders' capital and surplus proximately caused by [Moody's] negligent mismanagement, breach of fiduciary duties [and federal] securities violations...." The jury also awarded $1 million in punitive damages against Moody. This verdict was rendered in 1976; thereafter, Moody's lawyers filed an avalanche of post-trial motions raising over 80 alleged grounds of error that delayed the district court's entry of final judgment until 1979.

[30-33] Moody's attack on damages denounces what he characterizes as the numerous and "outrageous" errors of the district court. From his many briefs and supplemental briefs and letters filed in this appeal, we perceive his attack on the damages to be five-fold. First, he contends that Jim

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15. The damages here are, if anything, "special" or consequential damages because they are not the "necessary and usual result" of Moody's fraudulent valuation of the life interest, but rather are, as George's testimony (recounted in the text) shows, the proximate result thereof.

George used an improper method of accounting in calculating the value of Empire's assets. Second, he argues that Receiver was relieved of the burden of proving Empire's insolvency by being allowed to rely upon a prior adjudication of this matter in the Alabama courts. Third, Moody attacks the jury's award of $1 million in punitive damages.[16] We find no merit to his contentions. Before we discuss them, however, we summarize the damages evidence.

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16. Moody raises two other arguments which relate more closely to damages recoverable for a Rule 10-b violation.

First, he argues that George's testimony did nothing more than demonstrate a dilution of Empire's shareholders' equity, which Moody claims is not a compensable loss under existing precedent in this circuit. As support for this proposition, Moody cites a progression of Fifth Circuit cases, including *Herpich* v. *Wallace*, 430 F.2d 792 (5th Cir.1970); *Wolf* v. *Frank*, 477 F.2d 467 (5th Cir.), *cert. denied*, 414 U.S. 975, 94 S.Ct. 287, 38 L.Ed.2d 218 (1973); and *Sargent* v. *Genesco, Inc.*, 492 F.2d 750, 765 (5th Cir. 1974). In essence, Moody's argument is a back-handed attempt to attack Receiver's standing to maintain the Rule 10b-5 cause of action. He points particularly to *Wolf* v. *Frank*, a case in which the district court dismissed the plaintiff's individual 10b-5 claim because they "were unable to show any actual damages inasmuch as the dilution of their equity interest was not a cognizable element of damages for a violation of Rule 10b-5." 477 F.2d at 478. We affirmed the district court's action on the basis of our earlier opinion in *Herpich* v. *Wallace*, stating that the plaintiffs "[did] not have standing to seek individual damages for the dilution of equity interest caused by the [stock exchange in question] because plaintiffs were neither purchasers or sellers in connection with that transaction." *Id.*

Moody's argument misperceives our previous holdings in these cases. All three of these cases very plainly held that shareholders could assert a 10b-5 *derivative* action on behalf of a corporation although they were neither actual purchasers nor sellers. 430 F.2d at 809-10; 447 F.2d at 478-79; 492 F.2d at 762-66; *see Imperial Supply Co.* v. *Northern Ohio Bank*, 430 F.Supp. 339, 348 n. 6 (N.D.Ohio 1976). The present case is just such a derivative suit brought by Receiver, and so, even if we were to reach the issue of 10b-5 liability, it is clear that Receiver would have standing to assert such a claim. Moreover, the cases cited by Moody do not hold that dilution of stockholders' equity is never a compensable loss in 10b-5 actions, whether derivative or direct. They merely hold that dilution of shareholders' equity does not

At trial the chief damages witness for Receiver was Jim George, a manager in the Insurance Department of Alexander Grant & Co., a national accounting firm, and a former life insurance specialist with the international accounting firm of Peat, Marwick, Mitchell & Co. George testified that Alexander Grant & Co. had been retained by Receiver "to put together a complete accounting picture absent performing an audit of the entities involved in the birth, growth and demise of Empire . . . ." As a result, George and the

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confer "purchaser" or "seller" status on a plaintiff seeking to overcome the standing hurdle in a direct 10b-5 suit. Perhaps this distinction is best expressed by the court in *Sargent*: *"Thus, although dilution of equity may be an appropriate measure of damages, such dilution does not confer standing."* 492 F.2d at 765 (emphasis added).

Moody also argues that the district court should have awarded damages, if at all, under the "out-of-pocket" theory which, as he points out, is the usual measure of damages applied in Rule 10b-5 cases. Our declining to reach the issue of 10b-5 liability does not necessarily answer this argument because, as we have pointed out before, the "out-of-pocket" theory may also be applied at common law. *Huddleston* v. *Herman & McLean*, 640 F.2d at 555 & n. 34. We reject it as the proper measure of damages here, though, for the following reason. Under the out-of-pocket rule, a defrauded buyer is entitled to recover the difference between the price paid for securities and the real value when bought. *Id.* at 555-56. Under the unusual facts here, it is questionable whether this measure of damages could properly be applied to ascertain Empire's losses through its mergers and outright purchases of shares in other corporations for no allegation has ever been made that Empire did not receive "full value" when acquiring these securities, yet the evidence overwhelmingly demonstrates, as we have discussed in the text, that Empire suffered huge, tangible damages in the millions of dollars because of these acquisitions. Moreover, the acquisition program also involved the purchase of blocks of life insurance policies through bulk reinsurance agreements; such purchases did not involve securities, *see* 475 F.Supp. at 245. Thus, application of the out-of-pocket rule makes no sense in assessing damages suffered by Empire as a result of this aspect of its acquisition program. Yet these reinsurance agreements no less than the mergers and purchases of securities caused injury to Empire and were clearly compensable under the state law mismanagement action.

Insurance Department of Alexander Grant spent over one year examining the records and books of Empire for the period from 1963 to 1972. Scrutinized in the process were minutes of meetings of the board of directors, executive committee, and shareholders, proxy statements to shareholders, bulk reinsurance agreements and consents of insurance commissioners, mortgage loan files, annual financial statements, reports of state insurance examining departments, memoranda of officers and directors of Empire and its subsidiaries and controlled affiliates, and documents related to Empire's interest in the Libbie Shearn Moody Trust, including Ernst & Ernst's valuation of the trust.

George presented the results of this exhaustive analysis in his testimony at trial; the transcription of his testimony on direct examination alone covers 94 typewritten pages in the record before us. Basically, George described to the jury his method of measuring the damages suffered by Empire:

> All I did was take the years '64 through '72 as reported by the company, shoved them together and said fine, now summarize what caused the change in stockholders equity to be in the beginning three hundred ninety-four thousand and at the end, '72, be a $7,000,000 deficit, or a swing, if you please, of $7,400,000.

George concluded, based on his analysis of the change in stockholders' equity from Empire's inception to its ultimate receivership, that the cause of Empire's downfall was the aggressive acquisition program it had pursued; he also explained that the acquisition program would not have been possible without the artificial inflation of the trust value from $5,813,440 to 14,403,200:

> Q. [Counsel for Receiver]:
> Out of that study, we'll go back and analyze the segments, give us the ultimate conclusions.

Was there any particular cause of the company's collapse or were there hundreds of causes that are reflected by your studies of the financial history of Empire life?

A. [George]:

To point to one thing and say this caused, this transaction caused the demise, you couldn't do. You have to look at the entire program.

It was the total impact of the merger acquisition program creating huge drains on surplus of the insurance company that triggered or caused its insolvency.

Q. Did you come to any conclusion as to how Empire Life was able to embark and effectuate this acquisition program that you spoke of?

A. Yes, this is what I was trying to get across [a] while ago.

The contribution of the Trust Interest created equity, if you please, of $14,000,000. Had that equity not been there, it's my opinion that a merger acquisition program of the magnitude executed by the company could not have been done, could not have been attempted. The $14,000,000 increase in equity provided a right or a license, if you please, to use assets of the company to go on a merger acquisition program.

George also explained that the acquisition program had resulted in Empire's obtaining assets that, when valued under statutory accounting principles as required by state insurance law, were nonincome producing and had to be valued below their cost. In short, his testimony explained how Moody's acquisition scheme caused Empire to exchange liquid assets deemed "admitted" under state law, *e.g.*, cash and marketable securities, for noliquid assets statuorily valued at significantly less than cost. This left Empire with inadequate liquid assets, *i.e.*, cash reserves, with which to

pay its routine obligations such as policyholders' claims.[17] George testified that the difference between cost and statutory value of the property acquired by Empire was $9,207,242, *i.e.*, Empire's liquid and admitted assets were reduced by this amount as a result of the acquisitions. The low statutory value of the acquired property and its non-liquidity, when coupled with the sudden reduction in value of the trust interest by the Alabama Insurance Commissioner, rendered Empire statutorily insolvent. George reiterated that such insolvency was caused by the acquisition program:

> Q. [Counsel]:
>
> Was there any other cause reflected by the — your study of the financial statements that could have made — placed Empire Life Insurance Company into receivership, in an insolvent posture?
>
> A. [George]:
>
> I keep coming back to the same answer, the acquisition program.

George then stated that, in his view, Empire had suffered damages of somewhere between $7 and $10 million dollars. The $7 million or bottom figure was his calculation of the deficit and drain on shareholder equity caused by the acquisition and merger program; the top or $10 million figure represented the $14 million excess of Empire's liabili-

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17. In fact, the exchange of Empire's liquid, admitted assets for non-liquid, nonadmitted ones at times left Empire with little more than the income produced by the life interest to back up its routine obligations. Yet as noted earlier, although the life interest was valued at over $14 million, it only brought in about $200,000 yearly in actual income, an amount clearly inadequate to cover payments to policyholders and other business operating expenses. At trial an insurance examiner/expert for the State of Oklahoma, Ben Larson (who had studied Empire's financial condition in detail), testified that Empire's liquid capitalization was seriously inadequate to cover routine obligations even *before* the value of the life interest was inflated from $5 to $14 million.

ties over assets at the time it entered its bulk reinsurance agreement with Protective Life Insurance Co., less the $4 million value of the Moody trust interest at the time Empire entered receivership. George's extensive analysis and conclusions were borne out by the testimony of three other experts at trial (including former directors and officers of Empire) as was set forth in the opinion of the district court. 475 F.Supp. at 240.

a. *Asset Valuation*

Moody's most vehement attack on the damages evidence is directed toward George's method of calculating the value of Empire's assets. Moody raised this same contention in district court, whose characterization of it adequately summarizes his argument now:

> Moody attacks George's testimony on the ground that, if he had employed generally accepted accounting principles rather than statutory accounting principles, he would have valued the "downstream" assets that Empire acquired through its acquisition program much higher, and may have determined that Empire was in fact solvent at the time it entered receivership. Moody alleges that George relied solely upon statutory accounting principles in forming his opinion as to the damage caused by the acquisition program to Empire and therefore his testimony does not sufficiently prove that Empire suffered actual damages.

475 F.Supp. at 240.

Statutory accounting principles ("SAP") are rules that state insurance departments have developed to regulate life insurance companies; SAP mandate that conservative methods be employed in valuing the assets of such companies to guarantee their continuing solvency. D. Gregg & V. Lucas, *Life and Health Insurance Handbook* 1048 (3d ed. 1973); D. McGill, *Life Insurance* 860-61 (rev. ed. 1967).

This routine conservatism as reflected through use of SAP requires only that certain types of assets be considered in calculating a company's financial condition, and that the value of such "admitted" assets be determined according to quite restrictive rules. McGill, *Life Insurance* at 863-64. In short, it is clear that the standard practice in the life insurance industry is to determine the solvency of insurance companies by reference to SAP, even though, under generally accepted accounting principles ("GAAP"),[18] assets may be shown to have substantially greater value and might show a net equity of the company. 19 A.J. Appleman, *Insurance Law and Practice* § 10641 at 42 (1982); McGill, *Life Insurance* at 860-64; R. Strain, *Life Insurance Accounting* 353-54 (Merritt Co. ed. 1977); *In re American Investors Assurance Co.*, 521 P.2d 560, 562 (Utah 1974). George explained all of this at trial when he testified that life insurance companies are "'run and managed'" and "'bought and sold'" according to SAP. 475 F.2d at 242.[19]

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18. On the differences between SAP and GAAP, *see* D. Gregg & V. Lucas, *Life and Health Insurance Handbook* 1048-49 (3d ed. 1973); S. Huebner & K. Black, *Life Insurance* 528-80 (9th ed. 1976); D. McGill, *Life Insurance* 860-65 (rev. ed. 1967); R. Mehr, *Life Insurance* 658-60, 673-75 (rev. ed. 1977); R. Strain, *Life Insurance Accounting* 353-84 (Merritt Co. ed. 1977).

19. We are not at all certain from our reading of the record that George himself did not employ GAAP when calculating the dollar amount of Empire's insolvency. At trial George presented a summary of his calculations in a graph or chart entitled "Analysis of Changes in Stockholders' Equity" for Empire covering the years 1964-72. This chart, admitted into evidence during his testimony as an exhibit (PX # 19), specifically utilizes a dollar amount representing the value of Empire's nonadmitted assets in the calculation of its equity deficit. We also note that Moody's counsel never cross-examined George or the other experts as to whether they considered the value of Empire's nonadmitted assets or relied exclusively on SAP in calculating the amount of damages suffered by Empire.

In addition, we believe that valuation of Empire's assets under GAAP would not help Moody's position. The record reveals a

[34] The simple answer to Moody's argument about asset values is that Empire was insolvent under the law[20] and that the damages were determined after the assets had been transferred. If Moody had any support for the contention that the capital accounts would show a different balance if the assets were valued differently, he should have come forward with it.

b. *Prior Adjudication of Empire's Insolvency*

[35, 36] Moody also attacks the damages award by arguing that Receiver was relieved of the burden of proving

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letter from Peat, Marwick, Mitchell & Co. to Moody dated April 2, 1965, in which Peat Marwick transmitted the unaudited financial statement it prepared for Empire for the year ending December 31, 1964. This letter is significant because it represents the first time the value of the life interest was stated at the inflated value of $14,403,200. After noting the increased valuation placed on the life interest, Peat Marwick offered this caveat to Moody:

> You have informed us that this interest was acquired at no cost to the company. *In accordance with generally accepted accounting principles, the life interests in the Libbie Shearn Moody Trust should be valued at cost* rather than the computed value as determined by the actuary [$14,403,200] or the admitted value as shown by the annual statements [$5,813,440].

(emphasis added). Thus, if Moody followed GAAP in determining the value of the life interest, he should have listed its value in Empire's annual report as either $0.00, its "no cost" value, or $200,000, the amount of the surplus debenture that Empire transferred to Moody in consideration for his original assignment of 40% of his interest in the trust to Empire. Yet Moody ignored GAAP and the advice of Peat Marwick and caused the value of the life interest to be reported to shareholders as $14,403,200!

20. Alabama law expressly employs the use of SAP in calculating the solvency of life insurance companies. The Alabama Insurance Code very plainly spells out what kinds of insurance company assets are to be admitted or rejected. Ala.Code §§ 27-37-1, 27-37-2 (1975). These or similar statutory provisions have been in effect in Alabama since Empire began its acquisition program in the 1960's and were in force in 1972 at the time of its insolvency.

Empire's insolvency by being permitted to stand on a prior judicial adjudication of the issue. This contention is spurious. As recounted earlier, in 1974 Receiver sought an order to liquidate Empire and approve its bulk reinsurance by Protective Life. An Alabama receivership court granted such an order in a judicial proceeding in which Empire was adjudged to be statutorily insolvent in excess of $6 million and impaired in excess of $10 million. At the close of the trial in the instant case, the district court instructed the jury that Empire had been declared insolvent in the earlier Alabama proceeding and that such finding of insolvency was "binding on the parties at this time."[21] Moody contends that this instruction relieved Receiver of the burden of proving insolvency and the amount of damages suffered by Empire. We disagree.

First, the jury had already been informed of this adjudication of insolvency during testimony at trial (to which, we might point out, no objection was made). Second, at no time was the jury ever informed of the dollar amounts by which the Alabama court found Empire to be insolvent and impaired; indeed, the district court repeatedly stressed that the amount by which Empire was found to be insolvent in the Alabama proceeding could not be used as proof of damages in the instant case. Thus, it is impossible that the jury could have relied on the adjudication of the Alabama court in calculating the $5 million damage award it returned. Moreover, Receiver obviously did not purport to rely upon the Alabama adjudication as proof of the amount of damages that Empire suffered, but instead tendered the exhaustive testimony of George and other experts which we have already discussed.

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21. We note that Moody, in his reply brief, admits that he intervened as a codefendant with Empire in the Alabama proceeding brought by Receiver; as a result, he is bound by the adjudication there of the fact of Empire's insolvency.

c. *Moody's Day of Judgment*

[37-39] Punitive damages are not recoverable in a Rule 10b-5 action, but may be recovered under pendent state claims.[22] *Petrites* v. *J.C. Bradford & Co.*, 646 F.2d 1033, 1036 (5th Cir.1981). Moody argues that the district court erred in failing to instruct the jury that it could not consider any securities law violations in assessing punitive damages. Moody did not object at trial to the court's failure to give this cautionary instruction, however, and such failure may not now be assailed on appeal. Fed.R.Civ.P. 51. It is true that even absent objection we may consider errors in jury instructions that seriously affect the fairness and integrity of the proceedings. *Delancey* v. *Motichek Towing Service, Inc.*, 427 F.2d 897, 901 (5th Cir.1970); *Dunn* v. *Sears, Roebuck & Co.*, 639 F.2d 1171, 1176 (5th Cir.1981). However, Moody's wrongful conduct was the same whatever the basis of legal liability, and the court's failure to include a cautionary instruction relative to the legal basis for punitive damages could not result in a miscarriage of justice.

D. *Motion for Mistrial*

Moody raises one final argument for our consideration. He claims that the district court erred in failing to grant his motion for a mistrial based upon the allegedly prejudicial comments made by counsel for Receiver during closing jury argument. First, Moody claims that he was compared to Adolph Hitler. This claim is not entirely accurate. At one point during the examination of Richard E. Linn (an accountant with Empire and witness at trial) the parties were discussing a memorandum from Moody in which he issued directions to Empire's "field units." In

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22. Texas law permits punitive damages to be recovered under the facts of this case. *See Collins* v. *Miller*, 443 S.W.2d 298 (Tex.Civ.App. – Austin 1969, writ ref'd n.r.e.); *Williams B. Roberts, Inc.* v. *McDrilling Co.*, 579 S.W.2d 335, 340 (Tex.Civ. App. – Corpus Christi 1979, no writ).

trying to ascertain what Moody meant by the term "field units," counsel for Receiver commented that the term originated with Adolph Hitler in World War II. Counsel for Moody objected and the district judge sustained the objection.

Moody also claims that he was unfairly likened to criminals widely known by the public. This also occurred during closing jury argument of counsel for Receiver:

> The Court will instruct you that the insolvency of Empire Life Insurance Company of America has been determined by a court which Mr. Moody was a part of and he's further going to instruct you that the motives of the people that put it into insolvency are not relevant, are not material to any issue in this case. But, having heard the argument, let me remind you that everybody from Ben Jack Cage to Billy Sol Estes to Shearn Moody that's been in a suit like this has claimed politics and, indeed, Richard Nixon and Mr. Agnew have the same claim and they all, whenever there's no other defense, attack the attacker.
>
> In many ways, this case has been tried a little bit like a rape case. You don't defend yourself against the crime, you attack the integrity of the people who were had, who were injured. You attack the witnesses.

Moody did not object to these allegedly prejudicial comments at the time they were made, although he did object to them and moved for a mistrial upon a completion of Receiver's closing argument. The district court denied the motion for mistrial.

[40, 41] It is well-established that a motion for new trial based upon inflammatory remarks is addressed to the sound discretion of the trial judge, and his ruling thereon will not be disturbed absent an abuse of that discretion. *International City Bank & Trust Co.* v. *Morgan Walton Properties, Inc.*, 675 F.2d 666, 669 (5th Cir. 1982); *Crown Colony*

Distributors, Inc. v. *United States Fire Insurance Co.*, 510 F.2d 544, 545 (5th Cir. 1975). In the instant case, although the comments by Receiver's counsel may have been unnecessary and even unfortunate, we cannot say that the district judge abused his discretion in denying a motion for a mistrial. These comments occurred in two isolated and brief instances during the course of an extremely long and otherwise fairly litigated trial. From our review of the record, we cannot say that the " 'conduct of [Receiver's] counsel was such to impair gravely the calm and dispassionate consideration of the case by the jury . . . .' " *Crown Colony*, 510 F.2d at 545. We are convinced that the verdict in this case is rationally based on the convincing evidence at trial and is not the product of an impassioned jury swayed by a few passing references made by Receiver's counsel.

AFFIRMED.

APPENDIX B

In The

United States District Court

For The Northern District of Texas

Dallas Division

David C. Meyers, *Et al.*, *Plaintiffs* v. Shearn Moody, Jr., *Et al.*, *Defendants*	Civil Action No. CA-3-5678-D
AND	
Bernard Haines, *Et al.*, *Plaintiffs* v. Shearn Moody, Jr., *Et al.*, *Defendants*	Civil Action No. CA-3-7625-D
AND	
Charles H. Payne, *Receiver* v. Shearn Moody, Jr.	Consolidated

MEMORANDUM OPINION AND ORDER

The Defendant's Motion for Judgment on the Verdict; in the Alternative, for Judgment N.O.V.; and in the Further Alternative, for a Partial New Trial and for Dismissal for Failure to State a Claim Upon Which Relief Can Be Granted came on for consideration before the court, the Honorable Robert M. Hill, United States District Judge. The court has considered the motion and is of the opinion that the motion should be denied.

I. DAMAGES

Defendant Shearn Moody, Jr.'s (Moody) primary attack upon the jury's verdict in this case, camouflaged among some 82 alleged grounds of error, centers on its findings of damages. The jury found that five million dollars would compensate Empire Life Insurance Company of America (Empire) for damages caused by the depletion of its stockholders' capital and surplus proximately caused by Moody's negligent mismanagement, breach of fiduciary duty and violations of federal securities law. Court's Charge to the Jury (Charge), Question No. 10. It further found that Moody should pay one million dollars in punitive damages as a result of his intentional misconduct and gross negligence in managing Empire. Charge, Question No. 12. The court instructed the jury that, in determining Empire's damages, it should only consider "the amount of impairment at the time of Receivership, if any, to the corporation consisting of the loss of capital and paid in surplus." Charge at 21. Moody essentially contends that the court did not instruct the jury as to the correct measure of damages, and that the plaintiff, Empire's receiver (Receiver), did not present sufficient evidence to support an award of damages.

Waiver

At the outset, the court must determine whether Moody has waived his objections to the jury's verdict on damages for purposes of his motions for judgment n.o.v. and for a partial new trial. F.R.Civ.P. 50(a) requires that a motion for a directed verdict state the specific grounds therefor. Further, a party may not assert a ground in a motion for judgment notwithstanding the verdict that was not included in the motion for a directed verdict. 9 Wright & Miller, Federal Practice and Procedure, § 2537 at 598; *Sulmeyer* v. *Coca Cola Co.*, 515 F.2d 835, 846 (5th Cir. 1975). Moody

did assert in his motion for a directed verdict that Empire's insolvency is not the proper measure of its damages. (T. 1416). He did not, however, specifically contend that measurement of Empire's damages as of the time of the Alabama receivership adjudication was incorrect. Furthermore, he did not specifically contend as the ground for Receiver's failure to introduce sufficient evidence of damages the reliance of its experts witness upon an incorrect accounting method. (T. 1414-16). Therefore, he may not allege these grounds in a motion for judgment notwithstanding the verdict.

Federal Rules of Civil Procedure 46 and 51 govern whether Moody may present in a motion for new trial his objections to the jury's verdict on damages. These rules require that a party specifically and timely object to the introduction of evidence or to an instruction to the jury, and give specific grounds therefor, in order to preserve such objection for a motion for new trial. *See Patton* v. *Archer,* No. 77-1381 (5th Cir. Mar. 7, 1979); *Jamison Co.* v. *Westvaco Corp.,* 526 F.2d 922, (5th Cir. 1976); 9 Wright & Miller, Federal Practice and Procedure, § 2472. Since Moody did not object at trial to Receiver's expert testimony on damages on the specific ground that it was based upon improper accounting principles, he has waived any objection to the admission of such testimony. Moody did object to the submission to the jury of question 10 concerning damages on the ground that insufficient evidence supported its submission. (T. 2399). He also objected to the measure of damages set forth in question 10 on the ground that damages should be measured as of the time of each wrongful act alleged. (T. 2403). Accordingly, Moody may assert as grounds for new trial that plaintiff did not present evidence of sufficient weight to support the jury's finding of damages and that question 10 stated an improper measure of damages.

Measure of Damages

Receiver is entitled to recover on behalf of Empire compensation for losses proximately caused to the company by Moody's negligence and breach of fiduciary duty. *See Home Telephone Co.* v. *Darley,* 355 F.Supp. 992 (N.D. Miss. 1973), *aff'd per curiam,* 489 F.2d 1403 (5th Cir. 1974); *Hux* v. *Butler,* 339 F.2d 696, 701 (6th Cir. 1964); 19 C.J.S. Corporations § 833(d). Receiver may also recover on behalf of Empire damages proximately caused to it by Moody's violations of Rule 10b-5. *Moody* v. *Bache & Co., Inc.,* 570 F.2d 523, 527 (5th Cir. 1978); *Herpich* v. *Wallace,* 430 F.2d 792, 810 (5th Cir. 1970). This much is clear. What is not clear is how to measure the loss to Empire. Neither Texas law nor federal securities law provides a clear guideline, so this court must fashion a measure of damages which comports with the sparce precedent available and which is just. *See Spiegel* v. *Beacon Participations,* 297 Mass. 398, 8 N.E.2d 895, 909 (1937). There being no indication otherwise, the court presumes that the measure of damages for Receiver's common law and securities law claims does not differ under state and federal law. *Cf. Pappas* v. *Moss.* 303 F.Supp. 1257, 1281 (D. N.J. 1969).

In *Commonwealth of Massachusetts* v. *Davis,* 168 S.W.2d 216, 233 (Tex. 1942), the Texas Supreme Court indicated that corporate loss may be measured in terms of loss of value or physical damage to corporate assets, restraints upon the marketability of corporate assets, and interference with the development of corporate properties. The Supreme Judicial Court of Massachusetts in *Spiegel* v. *Beacon Participations* 297 Mass. 398, 8 N.E.2d 895, 909-911 (1937) assessed the damage caused to a corporation by an improper series of transactions according to loss in value of corporate assets. In *Spiegel,* certain directors of defendant Beacon Participations, an investment company,

authorized the investment of corporate funds in a joint venture with an investment company owned by two directors of Beacon Participations. The trial court found the responsible directors of Beacon Participations "grossly negligent" and in breach of their fiduciary duty to the company in authorizing this transaction because they did not require a capital investment or other security from the company's joint venturer and thus put Beacon Participations' capital at risk for the benefit of the joint venturer and not for the benefit of the company. The venture suffered losses in excess of $60,000. Since the responsible directors' wrongdoing consisted in the very entering of the joint venture and not in the particular transactions conducted by the venture, the court approved a rule of damages assessing the responsible directors for one-half the losses sustained by the joint venture as a result of transactions entered into while they remained directors. The court ruled that damages should be measured "according to general principles of gain and loss" as of the date of the final hearing to determine damages. *Spiegel, supra,* 8 N.E.2d at 911. Thus, the value of the stock remaining in the hands of the joint venture, sums realized from the sale of such stock, and contributions by the joint venturer were to be taken into account in calculating losses.

In *Insuranshares Corp.* v. *Northern Fiscal Corp.,* 42 F.Supp. 126 (E. D. Pa. 1941), a federal district court also analyzed damages caused to a corporation by a wrongful series of transactions according to loss in value of corporate assets. In that case the controlling shareholders of an investment corporation were found liable for turning over control of the corporation to persons who looted the assets of the company through a series of fraudulent transactions and who, in turn, transferred control of the corporation to another person, who looted the corporation further. The *Insuranshares* court interpreted the "ortho-

dox rule" of damages formulated in *Spiegel* to be the "difference in dollars between the assets of the plaintiff before the acts complained of and those found remaining at the time of suit" and applied a variant of that rule. The court varied from the *Spiegel* measure of damages in assessing damages as of the time of suit according to the loss in value of corporate assets caused by the defendant's wrongdoing less the increase in value of corporate assets also attributable to defendant's wrongdoing.

The measure of damages instructed to the jury in this case logically follows the formulations in *Spiegel* and *Insuranshares*. "The amount of impairment at the time of Receivership, if any, to the corporation consisting of the loss of capital and paid in surplus" proximately caused by the acquisition program negligently and fraudulently engineered by Moody takes into consideration the losses and gains in value of Empire's assets caused by Moody's wrongdoing and the increases and decreases in corporate liabilities caused by his wrongdoing. It measures loss according to general principles of gain and loss.

The measure of damages instructed to the jury differs from that employed in *Spiegel* and *Insuranshares* in that gains and losses are valued as of the time of the receivership adjudication. *Spiegel* applied a true rescissory measure of damages in determining loss as of the time of the hearing to determine loss. *See* Note, *The Assessment of Damages in Rule 10b-5 Cases,* 26 Stan. L.Rev. 371 (1974). As did this court, the *Insuranshares* court applied a rescissory measure of damages, but chose a post transaction date earlier than the date of the hearing to determine damages on which to measure damages. It measured damages as of the date of suit.

Moody contends that damages should be measured as of the time of each transaction constituting the acquisition

program. He thus argues for an out-of-pocket measure of damages. *See* Note, 26 Stan. L.Rev. 371 (1974). The Fifth Circuit recently applied an out-of-pocket measure of damages in a shareholder's derivative suit brought under Florida law to challenge a corporation's purchase of its own shares at an inflated price. *Schilling* v. *Belcher,* 582 F.2d 995, 1005 (5th Cir. 1978). *But see Dupuy* v. *Dupuy,* 551 F.2d 1005, 1024-25 (5th Cir. 1977); *Bird* v. *Ferry,* 497 F.2d 112 (5th Cir. 1974); *Colvin* v. *Dempsey-Tegeler & Co.* 477 F.2d 1283, 1288 n. 7 (5th Cir. 1973) (out-of-pocket measure of damages not applied). Although an out-of-pocket measure of damages may be proper in a suit challenging a market transaction entered into by a defendant with numerous sellers or buyers, plaintiffs in Receiver's position would be deterred from bringing suit if required to go to the expense of segregating a series of transactions over a number of years for purposes of calculating losses. *Cf. Daniels Towing Services, Inc.* v. *Nat Harrison Associates, Inc.,* 432 F.2d 103, 106 (5th Cir. 1970); *Hunter* v. *Shell Oil Co.,* 198 F.2d 485, 490 (5th Cir. 1952). Furthermore, an expert witness, James Lewis George (George), testified that Empire's loss was caused by the cumulative impact of the transactions constituting the acquisition program, (T. 597). A measure of Empire's loss which aggregated the separate impace of each transaction would therefore not be consistent with the cause of Empire's loss.

A commentator has suggested that courts sometimes measure damages as of a post transaction date other than the date of the hearing to determine damages because such a date is the earliest on which a precise valuation of loss can be made. Note, 26 Stanford L. Rev. 371, 375 (1974) Citing *Niles* v. *New York Central,* 68 N.E. 142 (N.Y. 1903), Moody contends in his memorandum of law (p. 24) — in the alternative, it appears, to his argument for an out-of-

pocket measure of damages — that the best date for valuing Empire's loss, if any, is some future date when Empire's assets are liquidated. Clearly, Receiver need not await Empire's liquidation to receive compensation for the loss incurred by Empire as a result of Moody's wrongdoing. *See Spiegel, supra,* 8 N.E.2d at 911. The date instructed to the jury on which to measure Empire's loss — the date of Receivership — is a proper date on which to assess damages in this case for two reasons. One, George testified that Empire's damages became measurable "at such time as the Insurance Commissioner stepped in and said the valuation of the Trust Interest is not an amount any where near the amount you are carrying it," (T. 598) and receivership adjudication shortly followed the devaluation of Moody's trust interest. Two, valuation of Empire as of the date of Receivership permitted the jury to take into account the impact of an adjudication of insolvency on Empire's value. *See* discussion at p. 11, *infra.*

In addition to being proper, the date instructed to the jury on which to measure Empire's damages is fair to Moody. One criticism of the rescissory measure of damages is that it permits market forces for which the defendant is not responsible to affect the amount of damages awarded. *See* Note *supra.* The Second Circuit justified a rescissory measure of damages — the difference between the purchase price of certain securities and the sale price of the securities — on the ground that the buyer would not have purchased the securities at any price but for the misrepresentations of the defendant, his stockbroker. *Chasins* v. *Smith, Barney & Co.,* 438 F.2d 1167, 1173 (2d Cir. 1970); *see Dupuy, supra,* 551 F.2d at 1025; *cf. Colvin, supra,* 477 F.2d at 1288 n.7. Since the evidence in this case shows that Empire *could not* have embarked upon the acquisition program *but for* the inflated trust interest (e.g., T. 542-43),

the court is justified on the ground adduced in *Chasins* in applying a rescissory measure of damages.

Under the circumstances of this case, furthermore, measurement of the loss caused to Empire by the acquisition program at a date later than the acquisitions themselves probably benefits Moody. Measurement of Empire's value following the acquisition program gives the "downstream investments" acquired by Empire during its acquisition program, *see* discussion at p. 8, *infra*, a chance to produce income and thereby mitigate Empire's loss. On the other hand, since it would become difficult to assess the damages attributable to Moody's actions after Empire had fallen into the hands of the Receiver, *cf. Insuranshares, supra*, 42 F. Supp. at 131, measurement of damages as of the date of Receivership avoids the possibility that Moody will pay for any losses caused by the Receiver. The court notes, finally, that Moody has not offered any evidence which would show that measurement of Empire's damages as of a given date would result in significantly lower damages than that achieved by measuring Empire's damages as of the date of Receivership. For the reasons set forth above, the court is of the opinion that it instructed a fair and proper measure of damages to the jury.

Proof of Injury and Damages

Receiver chiefly relies upon George's expert testimony to support the jury's award of damages. George testified that the increase in valuation of the Moody trust interest from approximately $5,800,000 to approximately $14,000,000 enabled Empire to embark upon an aggressive program of mergers with insurance companies, purchases of controlling interests in insurance companies, and purchases of blocks of insurance in force all of which "created huge drains on surplus" (T. 542) and ultimately caused damages to Empire measurable in 1972 in a range between $7,000,000 and

$10,000,000. (T 601-603). George explained that the acquisition program created drains on surplus because the assets acquired generated income "downstream." Hence, they were valued according to statutory accounting principles at an amount significantly below their costs. George labelled this difference between cost and statutory value as "unrealized investment losses" and calculated these to be $9,207,242 in his chart analyzing changes in stockholder's equity in Empire between 1964 and 1972 (Px. 19). The capital structure of Empire could withstand this drain or surplus only so long as the trust interest remained valued at $14,000,000. When it was devalued by the Alabama Commissioner of Insurance, Empire instantly became insolvent. Another expert, Hilton Painter, described the effect of the acquisition policy as "looting" the "good hard assets" of Empire (T. 137) because the acquisitions ultimately were supported by Empire's liquid assets rather than by the trust interest. Two other experts, Frank I. Schmidt and Ben Larson, concurred that the acquisition program caused Empire to become insolvent. (T. 319, 1279). Larson also opined that Empire made "bad acquisitions." (T. 1278-79). George's calculation that Empire incurred realized investment losses of $2,964,591 between 1964 and 1972 (Px. 19) supports this assessment.

George arrived at his range of damages by taking the stockholders' deficit of $7,000,000 generated by his analysis of changes in stockholders' equity from 1964-1972 as the low point of the range and by taking the $14,000,000 deficit "reflected in Best Reports concerning the ultimate bulk reinsurance" by Protective Life Insurance Company of Alabama (Protective) of Empire (T. 602), less a $4,000,000 value for the trust interest, as the high point. Protective, the highest bidder for Empire's assets and liabilities[1] after

1. The assets for which Protective bid did not include a fund of $2,000,000 retained by Receiver to pay creditors other than policy holders (T. 1177).

Empire entered receivership, required that a $13,000,000 moratorium be imposed for ten years on the cash values of insurance policies issued by Empire (T. 1180-82, 1244), evidence that, in real business terms as well as according to statutory accounting principles, Empire's liabilities significantly exceeded its assets in 1972.

Moody attacks George's testimony on the ground that, if he had employed generally accepted accounting principles rather than statutory accounting principles, he would have valued the "downstream" assets that Empire acquired through its acquisition program much higher, and may have determined that Empire was in fact solvent at the time it entered receivership. Moody alleges that George relied solely upon statutory accounting principles in forming his opinion as to the damage caused by the acquisition program to Empire and therefore his testimony does not sufficiently prove that Empire suffered actual damages.

George testified that statutory accounting principles are the rules that each state has evolved in regulating insurance companies, whereas generally accepted accounting principles have been established for stock life insurance companies by the accounting profession (T. 531). He also testified that there are material differences between the two methods of accounting (T. 531). Some evidence in the record, in addition to cases cited by Moody, specify certain of these material differences, DX 42 n.l.; *see, e.g., Norte & Co. Huffines,* 504 F.Supp. 1096, 1103 (S.D. N.Y. 1968), *aff'd in part, rev'd in part and remanded,* 416 F.2d 1189 (2d Cir. 1969); *Franklin Life Insurance Co.* v. *U.S.,* 399 F.2d 757 (7th Cir. 1968), but Moody nowhere has presented evidence cognizable by this court of a comprehensive valuation of Empire's assets and liabilities at the time Empire entered receivership according to generally accepted accounting principles. Rather, it has pointed to

the values of Empire's "non-admitted assets" as of December 31, 1970, included in Empire's Annual Statement and the NAIC Zone Examination Report of Empire (PX 80, Ex.B, p. 54; DX 37, p.14). Moody also relies upon testimony that a block of whole life insurance has a rule of thumb value for business purposes of one-and-one-half times the annual premium income of the block of insurance and no value according to statutory accounting principles (T. 989-990, 1339-1340). He then calculates the rule of thumb value of Empire's insurance in force in 1970 (DX 37, p.4) to underscore the inadequacy of George's determination of damages.

Moody's assorted examples of assets undervalued and non-valued under various theories do not persuade the court that Receiver's proof of damages is inadequate to support the jury's award. In determining whether proof of damages is "speculative," a court must first decide whether defendant's wrongdoing proximately caused injury in fact to the plaintiff. *Aldon Industries, Inc.* v. *Don Myers & Associates, Inc.*, 517 F.2d 188, 191 (5th Cir. 1975). If so, plaintiff need not prove the extent of damages with mathematical precision. Where the wrong is of such a nature as to preclude exact ascertainment of the amount of damages, the court need only determine, second, whether the jury could have made a just and reasonable inference of the extent of damages from the evidence. *Kestenbaum* v. *Falstaff Brewing Corp.*, 514 F.2d 690, 698 (5th Cir. 1975); *Daniels Towing Service, supra,* 432 F.2d at 106.

In accordance with this framework, the court makes the primary determination that the evidence supports a finding that Moody's common law and federal securities law violations proximately caused economic injury in fact to Empire. The expert testimony by George and others cited above sufficiently establishes a causal link between the fraudulent

valuation of the trust interest, the acquisition program, and injury in fact to Empire. Moody's contention that Receiver did not adequately prove injury in fact fails for several reasons.

First, Moody misreads George's testimony. George did not rely entirely upon statutory accounting principles to show that Empire suffered economic loss. Rather, he relied upon those principles to measure the extent of Empire's economic loss as of a particular date. The import of George's testimony was that Empire's rapid acquisition of downstream assets based upon a fraudulently created surplus destined its financial ruin, measured by any accounting method, upon discovery of the fraud and the proper valuation of its surplus. Thus, he testified that the acquisition program "ultimately put Empire Life Insurance Company into a category that would classify it as insolvent, both statutorily and otherwise." (T. 544).

Second, Moody does not consider the impact of receivership upon the value of Empire's assets. The evidence amply supports a jury finding that Moody should have foreseen at the outset of the acquisition program that Empire's statutory insolvency and entry into receivership would ensue upon the devaluation of its fraudulently inflated trust interest. Therefore, the jury could properly have measured Empire's assets as of the date it entered receivership according to their value under the circumstances of receivership and not according to their value on the open market. Protective's requirement of a moratorium shows that the value of Empire's assets under the circumstances of receivership were much less than the amount of its liabilities and that Empire had suffered actual economic loss.

Third, even ignoring the impact of receivership, Moody's alternative valuations of Empire's assets do not persuade

the court that Receiver has not sufficiently proven injury in fact. This court will not order a new trial on the highly speculative basis that, if required to value Empire's assets and liabilities according to methods other than statutory accounting principles, Receiver may be unable to prove injury in fact. The record does not indicate that the alternative methods of valuation proposed by Moody are superior to statutory accounting principles and does not contain a comprehensive valuation of Empire's assets and liabilities according to such alternative method.

Having determined that Receiver sufficiently proved injury in fact to Empire, the court turns now to the question of whether he adequately proved the extent of Empire's damages. George's testimony reveals that the injury to Empire caused by the acquisition program is not susceptible of exact determination. George testified to the overall detrimental impact of the acquisition program on Empire which became "measurable" only when the trust interest was devalued. (T. 596-98). Since Empire's damages may not be precisely determined, evidence supporting a reasonable approximation will suffice. *See Kestenbaum, supra,* 514 F.2d at 698. Furthermore, since Moody had the opportunity to present to the jury alternative methods of valuing Empire's assets, it cannot now complain that the measure of Empire's damages was not more precise. *See Fattore Co.* v. *Metropolitan Sewerage Comm'n.,* 505 F.2d 1, 6 (7th Cir. 1974).

The court is of the opinion that the Receiver presented evidence from which the jury could draw a just and reasonable inference of the extent of damages suffered by Empire. George testified that insurance companies are "run and managed" and "bought and sold" according to statutory accounting principles. (T. 531-32). In estimating a range of damages ($7,000,000 — $10,000,000) caused to

Empire by Moody's wrongdoing premised upon statutory accounting principles, George presented highly probative evidence to the jury of the extent of damages suffered by Empire. The $13,000,000 ten year moratorium imposed on the cash values of insurance policies issued by Empire was additional data on which the jury could base its damage award. The jury discounted George's estimate by $2,000,000, thus compensating for inaccuracies in his method of assessment which may have inflated the extent of Empire's damages. *See Locklin* v. *Day-Glo Color Corp.*, 429 F.2d 873, 884 (7th Cir. 1970). The Seventh Circuit, in *Fattore, supra,* permitted an award of damages to stand, even though premised upon a clearly incorrect method of computing damage, because the method employed was probative of the extent of damages and the trial judge rendered a "jury type verdict" by reducing the damage figure generated by the incorrect method. It by no means being settled that statutory accounting principles incorrectly measure the damages suffered by an insurance company, this court's decision to let the jury's verdict stand is less difficult than the *Fattore* court's decision.

Since Receiver proved that Moody's wrongdoing proximately caused injury in fact to Empire and adduced evidence upon which the jury could reasonably base its award of $5,000,000 compensatory damages, the court will not set aside the jury's finding of damages.

II. 10b-5 CLAIM

Moody makes a blunderbuss attack on the jury's finding that he violated Rule 10b-5. The jury found that "the increase in the value of the trust interest from 5.8 million to 14.2 million dollars together with the acquisition program was a devise, scheme or artifice to defraud by Moody in connection with the purchase and sale of securi-

ties," Charge, Question No. 6, and "an act, practice or course of conduct by Moody which operated as a fraud or deceit upon any person in connection with the purchase or sale of securities." Charge, Question No. 7. The jury also found that "Moody's failure to state that the trust interest was intended by Moody to be non-transferable by Empire was an omission to state a material fact necessary to make his representations about the value and admissibility of the trust interest not misleading and was omitted with the intent to deceive or defraud in connection with the purchase or sale of securities." Charge, Question No. 8. It found, in response to Question No. 9, that these violations of Rule 10b-5(1), (2), and (3) were a proximate cause of damages to Empire's stockholders "capital and surplus", and, in response to Question 16, that such damages amounted to $5,000,000. Moody contends that these findings, in light of the instructions given to the jury, do not state a violation of Rule 10b-5. The court will examine seriatim the elements of a 10b-5 action to determine whether the jury's findings in light of the court's instructions support the entry of judgment on Receiver's 10b-5 claim.

The basic elements of a 10b-5 action are: (1) conduct by the defendant proscribed by the rule; (2) a purchase or sale of securities by the plaintiff in connection with such proscribed conduct, and (3) resultant damages to the plaintiff. *Woodward* v. *Metro Bank of Dallas,* 522 F.2d 84, 93 (5th Cir. 1975).

Proscribed Conduct

Recent Supreme Court decisions have refined the sort of conduct proscribed by Rule 10b-5. Only conduct which can be fairly viewed as manipulative or deceptive is covered by Rule 10b-5. *Santa Fe Industries, Inc.* v. *Green,* 430 U.S. 462, 473-74 (1977). A person who engages in

deception in connection with the purchase or sale of a security does not violate Rule 10b-5 unless he intends to deceive the buyer or seller of the security. *Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185 (1976). Thus, a person who imparts false information to a buyer or seller of a security violates Rule 10b-5 if he knows of the falsity of the information or acts in reckless disregard of its falsity. *First Virginia Bankshares* v. *Benson,* 559 F.2d 1307, 1314 (5th Cir. 1977).

Although Questions 6 and 7 to the jury differ in wording in accordance with the differing language of subsection (1) and (3) of Rule 10b-5, they essentially inquire whether Moody has engaged in deceptive conduct. *See Santa Fe, supra,* 430 U.S. at 473-74; 1 A. Bromberg, Securities Law: Fraud, §2.6(1) at 49 (1977). The evidence more than adequately demonstrates that Moody employed deceit to increase the value of the trust interest from 5.8 million dollars to 14.2 million dollars. Empire's Annual Report of 1965, DX 7, first announced to Empire's shareholders a valuation of $14,213,440 for Moody's trust interest. Empire's annual report for the previous year had stated a valuation of $5,813,440 for the trust interest. DX 9. The 1965 annual report stated that "[v]aluation of the trust was calculated by the national auditing firm of Ernst & Ernst and actuaries including Mr. Lloyd K. Friedman, F.S.A., consulting actuary of Houston." DX 7, at p. 7. Ernst and Ernst, however, had not "calculated" the $14,213,440 value for the trust interest. Rather, it had approved the method employed by Lloyd K. Friedman (Friedman) to calculate the value of the two-fifth's of Moody's trust interest assigned to Empire at $5,813,440. DX 16, PX 35. The data underlying the trust valuation came from Moody and Friedman, not from Ernst & Ernst, in contradiction to the clear import of the statement that

Ernst & Ernst calculated the value of the trust interest. Furthermore Friedman employed a different method to calculate the value of Moody's trust interest at $36,084,000. DX 74. Under all the circumstances the jury could readily conclude that Moody deceived Empire's shareholders into believing that the increased value of the trust interest formed a solid foundation to support the acquisition program, when in reality the $14,213,440 value and shaky underpinnings.

The wording of Questions 6 and 7 implies an inquiry into Moody's intent to defraud Empire's shareholders. *See Ernst & Ernst, supra.* In connection with Question No. 6, the court defined "a device, scheme or artifice to defraud" as embracing an intent to deceive. Charge at 20. Since the evidence supports a finding that Moody intended to deceive Empire's shareholders as to the basis for the trust valuation, the jury's answers to Question No. 6 and 7 establish the element of "scienter" in Receiver's 10b-5 claim.

The court correctly defined "materiality" for [illegible] of Question No. 8, Charge at 20. *TSC Industries, Inc. v. Northway, Inc.*, 462 U.S. 438, 449 (1976); *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579, 603-04 (5th Cir. 1974). Under the evidence, the jury could reasonably find that Moody's omission to state that the trust interest was non-transferable was material and made with intent to deceive Empire's shareholders as to the value of the trust interest.

Moody contends that even if he deceived Empire's shareholders when he increased the trust valuation, he did not deceive Empire, for whom Receiver seeks recovery. The jury's finding that Moody dominated the business policy of Empire until at least March 21, 1970, by virtue of his power to nominate and elect a majority of the Board of Directors of Empire forecloses a finding that Moody deceived the Board of Directors in order to effectuate the acquisition

program. Charge, Question 15; *See Superintendent of Insurance* v. *Banker's Life and Casualty Co.*, 404 U.S. 6, 7 n. 1(1971). Since a majority of the board of directors carries on the business of a corporation and its knowledge is imputed to the corporation adherence to corporate formalism requires the conclusion that if a majority of board of directors of a corporation is not deceived the corporation is not deceived. The Fifth Circuit, however, has rejected this position as incompatible with the remedial purposes of Rule 10b-5. *Shell* v. *Hensley,* 430 F.2d 819, 826-27 (5th Cir. 1970); *Rekant* v. *Desser,* 425 F.2d 872, 878 n. 14 (1970). *Shell* did not articulate the "deception" involved when a majority of the board of directors of a plaintiff corporation authorizes a securities transaction with knowledge of the fraud connected with the transaction. The court perhaps relied instead upon the "new fraud" approach rejected by the Supreme Court in *Santa Fe. See Schoenbaum* v. *Firstbrook.* 405 F.2d 215 (2d Cir. 1968), *cert. denied,* 395 U.S. 906 (1969); Note, *Suits for Breach of Fiduciary Duty Under Rule 10b-5 After Santa Fe Industries, Inc.* v. *Green,* 91 Harv. L. Rev. 1874, 1882 n. 49 (1978). Although *Santa Fe* does not overrule *Shell,* it at least calls for an articulation of the deception suffered by a corporation when a majority of its directors participate in the deception. *See Goldberg* v. *Meridor,* 567 F.2d 209, 217-18 (2d Cir. 1977), *cert. denied,* 435 U.S. 956 (1978). The Third Circuit, prior to *Santa Fe,* theorized that when a majority of the board of directors participates in a deception proscribed by Rule 10b-5, the shareholders become the corporate entity for purposes of being deceived. *Pappas* v. *Moss,* 393 F.2d 865, 869 (3d Cir. 1968); *see Goldberg,* 567 F.2d at 217 (reaffirming theory of constructive deception); Note, 91 Harv. L. Rev. 1874, 1883, (1978) (principles of agency law and nature of a shareholders derivative suit are theoretical bases for "constructive deception" of a corporation through

minority shareholders. The Fifth Circuit appears to have adopted this theory of "constructive deception." In *Miller* v. *San Sebastian Gold Mines, Inc.*, 540 F.2d 807 (5th Cir. 1976), it held that a corporation could bring a 10b-5 action even though all the directors and shareholders of the corporation participated in the fraud. The persons deceived, according to the court, were the future shareholders of the corporation, who were the intended victims of the fraud.

This court instructed the jury that Empire's shareholders were among the persons whom Moody may have deceived in inflating the trust interest, Charge at 20-21, and related to the jury Receiver's contention that Moody deceived Empire's shareholders. Charge at 18. The jury's answers to Question 6, 7, and 8, therefore, can reasonably be construed as findings that Moody deceived Empire's minority shareholders. Under the theory of constructive deception, the jury's findings that Moody deceived minority shareholders of Empire[2] constituted findings that Moody so deceived Empire.

Purchase or Sale of Securities in Connection With Proscribed Conduct

The second basic element of a 10b-5 action seeks to establish a causal link between the conduct prescribed by rule 10b-5 — the intentional deception — and the purchase or sale of a security. In this case that causal link is between Moody's deceptive practices concerning the value of the trust interest and the acquisition program. The acquisition program involved three types of transactions: mergers; outright purchases of shares in other corporations; and purchases of blocks of life insurance policies through bulk

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2. Although Moody originally owned 100% of Empire's stock (T. 579, DX 43), various mergers created minority shareholders in Empire prior to the deceptions practiced in the 1965 annual report in connection with the increase in value of Moody's trust interest.

reinsurance agreements. (T. 575, 578, 785-88). Each time Empire merged with a corporation it purchased and sold securities. *See Smallwood* v. *Pearl Brewing Co.*, 489 F.2d 579, 590 (5th Cir. 1974). Empire's outright purchases of shares in other corporations were clearly the purchases of securities. Empire's purchases of blocks of life insurance were not, however, the purchases of securities. The significance of this fact will be explored later. For purposes of this discussion, it need only be stated that the acquisition program involved purchases and sales of securities.

The Fifth Circuit has broken down the proof of a causal link between the proscribed conduct and the purchase or sale of a security into the proof of two separate but overlapping elements: (1) actual reliance by the plaintiff upon the defendant's deceptive practices in deciding whether to purchase of sell a security; and (2) deceptive practices by defendant "in connection with" plaintiff's purchase or sale of securities. *See Rifkin* v. *Crow*, 574 F.2d 256 (5th Cir. 1978); *Moody, supra; First Virginia Bankshares* v. *Benson*, 559 F.2d 1307 (5th Cir. 1977); *Dupuy* v. *Dupuy*, 551 F.2d 1005 (5th Cir. 1977). The existence of a separate reliance element raises a question whether Receiver may recover judgment on his 10b-5 claim if the jury did not expressly find that Empire's shareholders relied upon Moody's deceptions concerning the value of the trust interest in assessing the propriety of the acquisition program. It is presumed that Empire's shareholders relied upon Moody's omission concerning the transferability of the trust interest. *See Rifkin, supra*, 574 F.2d at 262. Since the court instructed the jury that it should find "a device, scheme, or artifice to defraud" only if the device, scheme or artifice to defraud operated to deceive "persons who would predictably rely thereon," the jury's answer to Question No. 6 conceivably encompasses a finding of actual reliance upon Moody's affirmative misrepresentation concerning the value of the

trust interest. Even assuming the jury's answers to Questions No. 6, 7, and 8 do not include a finding of actual reliance, however, its answer to Question No. 9 necessarily involves a finding of actual reliance on Moody's misrepresentation. The jury could not have found that Moody's securities violations proximately caused damages to Empire without finding that Empire's shareholders actually relied upon those violations. *See Rifkin, supra,* 574 F.2d at 262 (reliance requirement "simply requires there to be a causal link between defendant's violation and plaintiff's harm in order for plaintiff to recover"). Whereas a finding of reliance does not necessitate a finding of causation, *see Moody, supra,* the converse is not true. If there is evidence to support the jury's finding of proximate cause, the element of reliance has been satisfied.

The jury's proximate cause finding also obviates the need for a separate finding that Moody's securities violations were "in connection with" the purchase or sale of a security. The Fifth Circuit may give "in connection with" a loose causal interpretation. In *First Virginia Bankshares, supra,* the court quoted the following formulation of the "in connection with" requirement from *List* v. *Fashion Park, Inc.,* 340 F.2d 457 (2d Cir. 1964): "whether the plaintiff would have been influenced to act differently than he did act if the defendant had disclosed to him the undisclosed fact." 559 F.2d at 1315. *See Wilson* v. *First Houston Investment Corp.,* 566 F.2d 1235, 1243 (5th Cir. 1978) (any purchase and sale of security "too remote" to satisfy "in connection with" requirement). *But see Superintendent of Insurance, supra,* 407 U.S. at 12-13 (corporation which suffers an injury as a result of deceptive practices "touching" its sale of securities entitled to recover under Rule 10b-5). *See generally* Note, *The Pendulum Swings Farther: The "In Connection With" Requirement and Pretrial Dismissals of Rule 10b-5 Private Claims for Damages,* 56 Texas L. Rev.

62 (1977). One commentator construes *Santa Fe, supra* 430 U.S. at 474 n. 14, as requiring, in the context of 10b-5 suits premised on "constructive deception" of shareholders, a causal link between the deception and the challenged securities transactions. Note, 91 Harv. L. Rev. 1874 (1978). This link is satisfied, the commentator argues, if the deception practiced by corporate directors upon shareholders precludes a shareholder's derivative suit to enjoin the securities transactions, regardless of whether such a suit would succeed. *See Goldberg, supra.* Although the definition of "in connection with" is in flux, one can safely assume that it does not entail a degree of causation more rigorous than proximate causation. *Cf. First Virginia Bankshares,* 559 F.2d at 1314 n.4. A priori, the "in connection with" requirement is met if there is evidence to support the jury's answer to Question No. 9.

The court is of the opinion that the jury had before it adequate evidence upon which to base its finding of proximate causation. The jury could readily find that the deceptive description of the Moody trust interest in Empire's Annual Report of 1965 had considerable impact upon Empire's minority shareholders. *See Rifkin, supra,* 574 F.2d at 261 n. 1. It could conclude that, had shareholders known of the shaky foundation upon which the increase in the value of the trust interest rested, they would have taken steps to halt the acquisition program. (T. 542-43). Since Moody could not have implemented the acquisition program but for the increase in value of the trust interest, shareholders could have halted the program by publicizing the facts surrounding the increase in value. The jury could reasonably conclude that dessimination of these facts to companies targeted by Empire for merger and to persons approached for non-cash sales of controlling shares in corporations would foil such transactions and lead to the

abandonment of the whole acquisition program. The jury could also have found that shareholders could have halted the acquisition program through a court injunction based on the same mismanagement and breach of fiduciary duty claims brought by the Receiver and decided by the jury that very day. *See Goldberg, supra.* There being adequate evidence to support the jury's finding that Moody's securities law violations proximately caused the acquisition program, the second basic element of Receiver's Rule 10b-5 action has been established.

Due Diligence

The Fifth Circuit requires that a plaintiff seeking recovery under Rule 10b-5 prove his "due diligence" as an element distinct from the actual reliance requirement. *Dupuy, supra; Clement A. Evan & Co.* v. *McAlpine,* 434 F.2d 100 (5th Cir. 1970). Under *McAlpine,* a plaintiff established his due diligence by proving that his reliance upon defendant's deceptive practices was reasonable under all the circumstances existing at the time of the deceptive practices. 434 F.2d at 103-04. *Dupuy,* a decision handed down after this case was submitted to the jury, announced a less stringent due diligence requirement responsive to the Supreme Court's holding in *Ernst & Ernst, supra.* Under *Dupuy* a plaintiff did not exercise due diligence if he intentionally refused to investigate in disregard of a risk known to him or so obvious that he must be taken to have been aware of it, and so great as to make it highly probable that harm would follow. 551 F.2d at 1020.

Moody contends in his Memorandum of Law at p. 47 that Receiver may not recover on his 10b-5 claim because the jury did not make a finding of due diligence. The jury's finding in response to Question No. 14, although in the context of Moody's statute of limitations defense, would seem to establish Empire's due diligence under *Dupuy.* The jury

found that Empire's shareholders other than Moody did not have knowledge of facts that would have caused a reasonably prudent person to make inquiry which would have led to a discovery before March 21, 1969, of the material circumstances surrounding the increase in carrying value of the trust interest and the acquisition program. To make this finding, the jury must have concluded that Empire's minority shareholders did not intentionally refuse to investigate a known or obvious risk concerning the value of the trust interest so great as to make it highly probable that harm would follow. Since, however, Moody had the burden of proving the shareholders' unreasonable delay in discovering Receivers' claims in Question No. 14, and Receiver would have the burden of proving due diligence, the jury's answer to Question No. 14 may not discharge Receiver's duty to establish due diligence.

The jury's failure to make a finding of due diligence, however, does not necessitate a new trial. Moody did not request an interrogatory or instruction to the jury concerning Empire's shareholders' due diligence in assessing the value of the trust interest and did not object to the omission from the charge of the issue of due diligence.[3] Under these circumstances F.R.Civ.P. 49(a) authorizes the court to make a finding on the issue of due diligence. Accordingly, the court finds that Empire's minority shareholders did not intentionally refuse to investigate a known or obvious risk concerning the value of the trust interest so great as to make it highly probable that harm would follow.

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3. At the time of this case, *McAlpine* had clearly established a due diligence requirement. That *Dupuy* altered the content of the requirement did not relieve Moody of the duty to object to the omission of the issue from the Charge if it wished to preserve its right to a jury determination.

Resultant Damages to the Plaintiff

The third basic element of a 10b-5 action concerns the causal link between the securities transactions caused by the defendant's proscribed conduct and the loss suffered by the plaintiff. *But see Moody, supra* (under one interpretation causal link between deceptive practice and loss is required; even though defendant's misrepresentation induced plaintiff to purchase a security — a discretionary account in commodities futures contracts — defendant not liable for losses incurred in trading of particular futures because plaintiff consented to such trading). The jury's answers to Question No. 9 and 10, adequately supported by the evidence, establish a causal link between Moody's deceptive practices and Empire's loss. In meeting the more stringent causation requirement that is one interpretation of *Moody*,[4] this jury finding establishes a causal link between the acquisition program and Empire's loss, thus satisfying the third basic element of a 10b-5 claim.

In the previous section the court upheld the jury's finding of $5,000,000 compensatory damages based upon evidence that the acquisition program caused damages amounting to at least that much. Having found that Moody breached common law duties owed to the corporation by implementing the acquisition program, the jury reasonably

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4. *Moody*, 570 F.2d at 572 n. 7 expressly denies that it is requiring anything more than proof of "transaction causation": a causal link between the defendant's deceptive practices and plaintiff's securities transactions. One possible interpretation of the court's decision which conforms with this denial is that, since the plaintiff consented to the trading of those futures which resulted in his loss, he would have entered into those transactions regardless of whether he had "purchased" the discretionary commodities account from the defendant. A third interpretation of *Moody* is that at the time of the futures trading which caused plaintiffs' losses defendant's misrepresentation was no longer material. 570 F.2d at 528.

considered the loss attributable to the acquisition program in calculating the damages recoverable on Receiver's common law claims. It is more problematic, however, to permit the jury's finding of damages recoverable on Receiver's securities law claims to stand if premised also on the loss to Empire caused by the acquisition program. Moody violated the securities laws only in connection with transactions in the acquisition program which were purchases or sales of securities. He did not violate the securities laws when Empire purchased blocks of life insurance from other companies. If the jury considered the whole acquisition program in determining the damages caused by Moody's securities law violations, it took into account losses caused by transactions other than purchases or sales of securities. The court must determine, first, whether the jury did consider the purchases of blocks of life insurance in assessing damages for Moody's securities law violations and, if so, second, whether the jury erred in considering those transactions.

The court instructed the jury that the bulk insurance transactions were not securities transactions. Charge at 20. It did not, however, instruct the jury that it was not to take the bulk insurance transactions into account in assessing damages for Moody's securities law violations. Rather, the court stated the Receiver's contention in connection with his 10b-5 claim that the acquisition program embarked upon by Moody was the proximate cause of the ultimate damage to Empire Charge at 18. It is doubtful that the jury found identical damages for Moody's breach of common law duties and for his securities law violations and omitted consideration of the bulk insurance transactions in assessing damages on the securities law claims. As no evidence was introduced to show the loss to Empire caused by the acquisition program less the bulk insurance trans-

actions, it is even more unlikely that the jury made such a finding in response to Question No. 10.

The court is of the opinion that the jury did not err in taking into account the bulk insurance transactions in assessing damages for Moody's securities law violations. The jury could reasonably have determined that Moody would not have engaged in the acquisition program at all if he had been unable to enter into the securities transactions forming the basis for Receiver's 10b-5 claims. Thus it could have found that Moody's securities law violations caused the entire acquisition program which caused a loss to Empire of $5,000,000. Even if the securities law violations did not cause the bulk insurance transactions, the jury was entitled to consider those transactions in determining damages on Receiver's 10b-5 claims. As discussed above, the transactions constituting the acquisition program are inextricably bound with reference to Empire's loss. No one kind of transaction caused Empire's loss. To require proof that the securities transactions alone caused Empire's loss and proof of the extent of that loss would foreclose Receiver's 10b-5 claims. It should be Moody's burden to prove what amount of Empire's loss, if any, is not attributable to his violations of Rule 10b-5. *See Daniels Towing Service, supra.* Since Moody presented no such evidence in mitigation of Empire's loss, the jury was entitled to charge him with the loss attributable to the entire acquisition program.

For the reasons set forth above, the court is of the opinion that the jury's findings support the entry of judgment on Receiver's 10b-5 claims in the amount of $5,000,000.

III. ESTOPPEL

Citing *Bangor Punta Operations, Inc.* v. *Bangor and Aroostock R.R.*, 417 U.S. 307 (1974), Moody contends that Receiver is equitably estopped from bringing this suit on behalf of Empire because the proceeds of the suit will go to Protective under the Fourth Amendment to Treaty of Assumption and Bulk Reinsurance (Treaty), PX 73. The decision in *Bangor Punta* turned on the equitable principle that a purchaser of all, or nearly all, of a corporation's shares may not sue his seller for corporate mismanagement. 417 U.S. at 425. If permitted to recover from his seller, the purchaser would obtain a windfall, assuming he paid the fair market value of the shares, and would, in effect, recover his purchase price from the seller. 417 U.S. at 425-26. Finally, recovery would permit the seller to profit from the wrongs done to others and thus would encourage further such speculation. *Id.*

Bangor Punta does not compel dismissal of this suit on its facts or on its principles. Protective did not purchase any shares of Empire. Rather, it acquired most of Empire's its assets and liabilities under a bulk reinsurance agreement after Empire had been adjudicated involvent and placed in receivership. The assets transferred to Protective expressly did not include the causes of action sued upon in this case. Since Protective acquired an insolvent company, it required a moratorium on the cash values of insurance policies issued by Empire. The proceeds of this suit will be received by Protective and applied to reduce the Moratorium Amount established in the bulk reinsurance agreement. Treaty at 2. They will not be a windfall for Protective. Protective will not thereby recover the "purchase price" of Empire. Finally, it will not profit from wrongs done to others. It flies in the face of equity for Moody to argue that he may avoid compensating Empire

for the loss he caused it because the Receiver has chosen to benefit the creditors of Empire with the proceeds of this suit.

IV. McCARRAN-FERGUSON ACT

Moody contends that the McCarran-Ferguson Act, 15 U.S.C. § 1012(b) forbids Receiver's 10b-5 claims because they involve the construction of an Act of Congress that would "invalidate, impair or supercede" Alabama law regulating the accounting of insurance companies and hence the "business of insurance." Even assuming that the Alabama law which regulates the accounting of insurance companies concerns the "business of insurance" because it is designed to protect the security of policyholders, *see SEC* v. *National Securities, Inc.*, 393 U.S. 453, 461-62 (1969), Receiver's suit under the Securities Exchange Act of 1934 does not "invalidate, impair, or supercede" such law. In *National Securities, supra,* the Supreme Court held that the state law under which an insurance commissioner approved a merger between two insurance companies was not impaired by a SEC action to enjoin the merger. According to the Court, the insurance commissioner viewed the merger from the standpoint of its impact on policyholders and the SEC sought to protect the shareholders of the companies from misrepresentations made in connection with the merger. Since the Court had determined that shareholder protection did not involve the business of insurance, it concluded that the SEC's suit would not impair the law under which the insurance commissioner approved the merger, even though, if successful, it would undo the merger.

In this case, the Receiver's suit seeks recovery for losses caused by securities transactions entered into as a result of Moody's deceptive practices in connection with the valuation of the trust interest. Empire's purchases of securities

were not the "business of insurance" because they did not directly involve the relationship between the insurance company and its policyholders. *See Group Life & Health Insurance Co.* v. *Royal Drug Co.*, 47 U.S.L.W. 4203 (February 27, 1979); *National Securities, supra.* Unlike the facts of *National Securities*, recovery by Receiver on his 10b-5 claim would not even have required that the Alabama Insurance Commissioner revise the value at which Empire holds Moody's trust interest. Federal securities law merely required full disclosure of the facts surrounding the valuation of the trust interest for the benefit of the corporation's investment decisions. It did not impair the Alabama Insurance Commissioner's valuation of Empire's assets in accordance with statutory accounting principles for the benefit of Empire's policyholders. As in *National Securities, supra*, 393 U.S. at 463, there was no conflict.

V. OTHER GROUNDS OF ERROR

Several grounds of error asserted by Moody have already been considered by the court and do not require reconsideration. The remaining grounds can be quickly disposed of.

The court is of the opinion that sufficient evidence supports the jury's findings in response to Questions No. 14-17. The evidence also adequately demonstrates Moody's responsibility for the liability producing acts found by the jury. The forms of the interrogatories submitted to the jury are not confusing or misleading. The jury did not award punitive damages for Moody's securities law violations. Rather, its award of $1,000,000 punitive damages in response to Question No. 12 is tied to its finding of Moody's breach of common law duties in Question No. 3. The court did not submit a damage issue to the jury with respect to Question No. 4 because the damages suffered by Empire

as a result of Moody's self-dealing did not present an issue of fact. The evidence shows that, as a result of Moody's self-dealing, Empire transferred on July 1, 1971, over $319,000 to W. C. Moody Bankers (PX 70) and received nothing in return. All other grounds of error raised by Moody are overruled.

VI. CONCLUSION

In accordance with the jury's verdict the court shall enter judgment on Receiver's self-dealing claim in the amount of $319,000. It shall also enter judgment on his mismanagement and breach of fiduciary duty claims and on his 10b-5 claims in the amount of $5,000,000. Further, the court shall enter judgment for punitive damages on Receiver's mismanagement and breach of fiduciary duty claims in the amount of $1,000,000. Under Texas law, the court is required to award pre-judgment interest as damages on Receiver's common law claims if the principal damages are determinable and established at a definite time either by rules of evidence or known standards of value. *McDaniel* v. *Tucker,* 520 S.W.2d 543, 549 (Tex. Civ. App. — Corpus Christi 1975, *no writ*); *Colonial Refrigerated Transportation, Inc.* v. *Mitchell,* 403 F.2d 541, 554 (5th Cir. 1968). *But see Phillips Petroleum Co.* v. *Adams,* 513 F.2d 355, 366 (5th Cir.) *cert. denied,* 423 U.S. 930 (1975). The damage to Empire caused by Moody's self-dealing became definite and ascertainable on July 15, 1971, when Empire funds were transferred to W. L. Moody Bankers. The damages suffered by Empire as a result of Moody's mismanagement and breach of fiduciary duty became definite and ascertainable as of the date of Receivership, July 1, 1972. Accordingly, the court shall award pre-judgment interest on Receiver's common law claims from these dates. One question remains: at what rate of interest shall prejudgment interest be awarded?

Unfortunately, the Texas law is not clear. *Watkins* v. *Junker,* 90 Tex. 584, 40 S.W. 11 (1897) stated that "the courts have, by analogy, adopted the legal rate of interest fixed by statute as the standard by which to be governed in assessing damages for the detention of money." Texas law provides for two legal rates of interest. Tex. Rev. Civ. Stat. Ann., art. 5069-1.03 allows pre-judgment interest on "written contracts ascertaining the sum payable" and on open accounts at the rate of six percent. Since September 1, 1975, Tex. Rev. Civ. Stat. Ann., art. 5069-1.05 has provided for post-judgment interest at the rate of nine percent. In a Memorandum Opinion and Order entered November 29, 1978, in *Hadra* v. *Herman Blum Consulting Engineers,* CA-3-75-1041-D, this court determined that pre-judgment interest as damages should be awarded at a rate of six per cent. A review of the case law revealed no discussion of the issue of which rate to apply, but uncovered applications of both the nine per cent and the six percent rates. *See Earl Hayes Rents Cars & Trucks* v. *City of Houston,* 557 S.W.2d 316, 322 (Tex. Civ. App. — Houston [1st Dist.] 1977, writ ref'd n.r.e.); *City of Ingleside* v. *Stewart,* 554 S.W.2d 939, 946-47 (Tex. Civ. App. — Corpus Christi, 1977, *no writ*). Resorting to the language of *Watkins,* this court concluded that art. 5069-1.03 provided the more appropriate analogy for prejudgment interest as damages because it provides specifically for prejudgment interest. Furthermore, to award pre-judgment interest as damages at a rate of nine per cent would emasculate art. 5069-1.03. As stated in *Hadra, supra,* the court feels bound to apply a six percent rate to pre-judgment interest awarded as damages until the Texas legislature remedies the disparity in legal rates of interest or the Texas courts resolve the issue of which rate to apply.

The court is not bound by state law in determining whether to award pre-judgment interest on Receiver's securities law claims. Whether to award pre-judgment interest is a question of fairness resting within the district court's sound discretion, *Wolf* v. *Frank,* 477 F.2d 467, 479 (5th Cir. 1973). Under the circumstances of this case, the court is of the opinion that Receiver should be awarded pre-judgment interest at the rate of six per cent from the date of Receivership, July 1, 1972. Moody's personal wrongdoing was established by the jury's findings. *See Norte & Co.* v. *Huffines,* 416 F.2d 1189, 1191-92 (2d Cir. 1969). Further, Empire was deprived of the opportunity to invest the $5,000,000 awarded by the jury as damages. *Id.* at 1192. Finally, Moody is at least as responsible as Receiver for the time elapsed in bringing this suit to judgment. *Id.* Moody's voluminous post trial briefs attest to that.

Defendant's motions are denied; it is so ORDERED.

Dated this 29th day of May, 1979.

United States District Judge

APPENDIX C

United States Court of Appeals

FOR THE
FIFTH CIRCUIT

No. 80 - 1145

D.C. DOCKET NOS. CA-3-5678-D AND CA-3-7625-D

DAVID C. MEYERS, *Et al.*
Plaintiffs-Appellees

v.

SHEARN MOODY, JR.
Defendant-Appellant

BERNARD HAINES, *Et al.*
Plaintiffs-Appellees

v.

SHEARN MOODY, JR.
Defendant-Appellant

THORPE FORRESTER,
Receiver-Appellee

v.

SHEARN MOODY, JR.
Defendant-Appellant

APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE
NORTHERN DISTRICT OF TEXAS

BEFORE THORNBERRY, REAVLEY and JOHNSON, Circuit Judges.

JUDGMENT

This cause came on to be heard on the record on appeal and was argued by Counsel;

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the judgment of the said District Court in this cause be, and the same is hereby affirmed;

It is further ordered that defendant-appellee pay to plaintiffs-appellees, the costs on appeal to be taxed by the Clerk of this Court.

December 23, 1982

Issued as mandate: March 28, 1983

APPENDIX D

IN THE

United States Court of Appeals

FOR THE FIFTH CIRCUIT

No. 80-1145

DAVID C. MEYERS, *et al.*,
Plaintiffs-Appellees,

v.

SHEARN MOODY, JR.,
Defendant-Appellant,

BERNARD HAINES, *et al.*,
Plaintiffs-Appellees,

v.

SHEARN MOODY, JR.,
Defendant-Appellant,

THARPE FORRESTER,
Receiver-Appellee,

v.

SHEARN MOODY, JR.,
Defendant-Appellant,

APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF TEXAS

ON SUGGESTION FOR REHEARING EN BANC

(Opinion 12/23/82, 5 Cir., 198 , ... F.2d .....).

(March 1, 1983)

Before THORNBERRY, REAVLEY and JOHNSON, Circuit Judges.

PER CURIAM:

(✓) Treating the suggestion for rehearing en banc as a petition for panel rehearing, it is ordered that the petition for panel rehearing is DENIED. No member of the panel nor Judge in regular active service of this Court having requested that the Court be polled on rehearing en banc (Rule 35, Federal Rules of Appellate Procedure; Local Fifth Circuit Rule 16), the suggestion for Rehearing En Banc is DENIED.

( ) Treating the suggestion for rehearing en banc as a petition for panel rehearing, the petition for panel rehearing is DENIED. The judges in regular active service of this Court having been polled at the request of one of said judges and a majority of said judges not having voted in favor of it (Rule 35, Federal Rules of Appellate Procedure; Local Fifth Circuit Rule 16), the suggestion for Rehearing En Banc is DENIED.

Entered For The Court:

/s/ THOMAS M. REAVLEY
United States Circuit Judge

Office-Supreme Court, U.S.
FILED
AUG 19 1983
STEVAS,
CLERK

No. 82-2091

IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

SHEARN MOODY, JR.,
Petitioner,

v.

DAVID C. MEYERS, et al.,
Respondents.

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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QUESTIONS PRESENTED

Whether the federal court below correctly denied Moody's defense of equitable estoppel based on an assumption of approval of valuation of an insurance company asset when such approval is obtained by fraud.

Whether the federal court of appeals correctly applied state law to the principle of equitable estoppel.

Whether the principles set forth in *Bangor Punta Operations, Inc., v. Bangor & Aroostook Railroad*, 417 U.S. 703 (1974) are applicable to this judgment.

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BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

INTRODUCTION

The Petition before this Court is the ninth in a series of petitions for writ of certiorari filed by Shearn Moody, Jr., arising out of the domiciliary and ancillary receivership proceedings in the Courts of Alabama and Texas involving Empire Life Insurance Company of Ameria (Empire). Petitioner (Moody) was the chief executive officer of Empire, an insolvent Alabama insurance company. Respondent is actually the Receiver of Empire, William G.

Ward, Jr. (Receiver). Citations to related litigation are listed below:

Ex parte Moody, 418 So. 2d 93 (Ala. 1982) cert. denied Moody v. Forrester — U.S. — (51 U.S. Law Week 3612, Feb. 22, 1983).

Sumrall v. Moody, 620 F. 2d 548 (5th Cir.) on rehearing 632 F. 2d 1351 (5th Cir.), cert. denied, 450 U.S. 1026 (1981).

Moody v. State ex rel. Payne, 335 So. 2d 1116 (Ala.), cert. denied, 439 U.S. 910 (1978).

Moody v. State ex rel. Payne, 351 So. 2d 552 (Ala. 1977), cert. denied, 435 U.S. 969 (1978).

Empire Life Insurance Co. of America v. Moody, 584 S.W. 2d 855 (Tex. 1979).

Moody v. State ex rel. Payne, 351 So. 2d 547 (Ala. 1977), cert. denied, 434 U.S. 835 (1977).

State ex rel. Payne v. Empire Life Ins. Co., 351 So. 2d 538 (Ala. 1977), cert. denied, 435 U.S. 969 (1978), rehearing denied, 434 U.S. 1089 (1978).

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Moody v. Texas, 538 S.W. 2d 158 (Tex. Civ. App. 1976), writ ref'd n.r.e.), cert. denied, 434 U.S. 1068 (1978).

Moody v. Moody Nat'l Bank, 522 S.W. 2d 710 (Tex. Civ. App. 1975, writ ref'd n.r.e.).

Moody v. Crook, 520 S.W. 2d 958 (Tex. Civ. App. 1975).

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Moody v. Jones, 519 S.W. 2d 536 (Tex. Civ. App. 1975).

Empire Life Insurance Co. v. State, 492 S.W. 2d 366 (Tex. Civ. App. 1973).

Day v. State, 489 S.W. 2d 368 (Tex. Civ. App. 1972).

STATEMENT OF THE CASE

1. **Background**—Petitioner Shearn Moody, Jr. is the former president, Chairman of the board of directors and principal stockholder of Empire Life Insurance Company of America. On June 29, 1972, Empire was found to be impaired and insolvent and placed in receivership by the Circuit Court of Jefferson County, Alabama. Empire was adjudicated insolvent on the grounds that a major asset of Empire, an interest in the Libbie Shearn Moody trust ("the Trust"), had been overvalued by Empire. Though an appeal from this adjudication was expressly authorized by Alabama law, Moody did not appeal. *Moody v. State, ex rel. Payne*, 344 So. 2d 160, 164 (Ala. 1977) cert. denied, *Shearn Moody v. Charles H. Payne, etc.*, 434 U.S. 996 (1977).

By March, 1972, several stockholders had filed a derivative action against Moody for breach of fiduciary duty, mismanagement and common law fraud. This action was taken over by the Receiver of Empire, the Commissioner of Insurance, State of Alabama, John G. Bookout. The Receiver's complaint was filed in June of 1974. The case proceeded to trial in December, 1976 with a verdict being rendered in favor of the Receiver in January, 1977. Following extensive post-trial briefing, the Court entered judg-

ment in favor of the Receiver in May of 1979.

2. **The Case That Was.**

> "A critical *factual issue* has been the designation of responsibility for the $14,403,200 value placed on the life interest. Moody claimed that responsibility rested with national accounting firms, an independent actuary and the Alabama Superintendent of Insurance. The jury found that the value increase was done by Moody as part of a scheme to defraud. As will be seen, that finding is supported by the evidence." (Emphasis supplied) (Appendix A-2).

During the course of trial, at least six (6) witnesses offered by the Receiver testified in detail as to Moody's negligence and breach of fiduciary duty including three (3) insurance executives who had worked under Moody at Empire. Multiple witnesses testified that the cause of the demise and collapse of Empire was due to Moody's reckless acquisition program which could not have been implemented but for the mark up valuation of the Moody trust interest from $5.8 million to $14.2 million within the space of one (1) year in the early stages of history of that company (1965-66). Three experts (accountants, actuaries and insurance executives) detailed their opinions based upon extensive studies of the record of Empire to the extent of damage.

The Receiver's proof of ultimate fact issues went virtually unchallenged. Moody put no experts on the stand. Moody produced no witnesses to contest the evidence of fraud, to attest to the prudence of his management or to the advisability of undertaking the extended program of acquisition and expansion utilizing the artificial surplus created by the valuation of the life interest in the Moody trust. Indeed, Moody did not even produce an independent witness to support the 1965 $14 million valuation on the trust. Moreover, Moody's counsel chose not to confront the

substantive testimony seeking only to impeach the legitimation of the Receiver's fact witnesses.[1]

At trial the Receiver did not attack the acquisition program as such even though there were indeed bad aquisitions. Rather, it was the fraud, imprudence and negligence of allowing an under capitalized life insurance company to embark upon an aquistion program by virtue of a paper surplus of $14 million established without appraisal or verification when Empire was receiving between $165,000 to $250,000 income from the trust and did not have true surplus asset resources with which to withstand the risk of such growth and attendent expenses. Moody's defense was that he relied upon the Alabama Insurance Commissioner's approval of the $14 million valuation (which he fraudulently induced) and would not have done anything in terms of acquisition policy without that approval. No one appeared for Moody to say that he relied on his own fraudulently obtained approval.

Moody's witness, former Alabama Insurance Commissioner, Frank Ussery, conceded that an appraisal was a necessary predicate to an approved valuation by his department. He further testified that he had assumed, as late as 1971, that the valuation placed by Empire on the trust interest was predicated on an appraisal, which the evidence established never occurred, although Moody fraudulently represented it had.

There was no evidence of any "valuation" made by the State of Alabama. To the contrary, the overwhelming evi-

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[1] Certainly there can be no inference as to inadequacy of representation. Moody's counsel were the best. At trial, were the reknown trial lawyers John Hauer of Dallas and Roy Cohn of New York together with Dean Carlton, Professor Allen Bromberg joined by the firm of Jenkins & Gilcrest. In addition to quality, Moody also had quantity. By count, Moody had 12 separate law firms of counsel of record through the time of jury verdict and that figure now numbers 24.

dence was simply that the State of Alabama accepted the valuation placed on the trust by Moody and that acceptance was premised on a false assumption fraudulently induced, that an appraisal of the trust had been made for $14.2 million by Ernst and Ernst and/or Peat Marwick and Mitchell.

REASONS FOR DENYING THE WRIT

With liability based solely upon state law grounds, the decision of the Fifth Circuit in this case raised no important federal questions. The court properly applied well-settled concepts of state law in affirming the jury's findings of intentional misconduct, gross negligence and violation of Moody's fiduciary duties.

Moody's Petition revolves around and seeks relitigation of factual issues that were decided against Moody by the jury, the district court and the Court of Appeals. In order to reverse the court below, this Court would be called upon to review the factual findings of the jury and to determine that they should be set aside. Granting this Petition would be contrary to this Court's policy that "we do not grant a certiorari to review evidence and discuss specific facts." *United States v. Johnston*, 268 U.S. 220, 227 (1925).

ARGUMENT

I.

DEFERENCE TO STATE ADMINISTRATION OF STATE PROGRAMS

> "Moody also argues that Receiver is equitably estopped from bringing this action because Moody increased the value of the life interest and pursued the subsequent acquisition program in reliance on the approval issued by Empire's shareholders and board of directors and that Alabama Department of Insurance. *The sole virtue of this contention is audacity.* The

> doctrine of estoppel is for the protection of innocent persons, and only the innocent may invoke it. A party may not invoke an estoppel for the purpose of shielding himself from the results of his own fraud, dereliction of duty, or other inequitable conduct." (Emphasis supplied) (A-19).

The above quotation from Judge Reavley's excellent opinion in the Court of Appeals, *Moody v. Meyers, et al*, 475 F. Supp. 232 (5th Cir. 1982) best answers the argument presented here by Moody.

Moody starts with an assertion that there is a duty on the part of the Insurance Department of the State of Alabama to "value" the assets of the insurance companies operating within its borders.[2]

Moody next leaps to the conclusion that there is in fact a valuation by the Commissioner of Insurance of the State of Alabama and states:[3]

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[2] Moody's argument of Alabama law is nothing short of incredible. Moody cites Title 28, Section 61, *Code of Alabama Recompiled 1958*, (totally inappropriate, this section is the standard valuation of reserves section of 1958 requiring companies to value reserves in accord with standard tables and any assets to meet those reserves.) He also cites Section 27-37-1 *Code of Alabama 1975*. His obvious reference is to:

> "(13) Other assets, not inconsistent with the provisions of this section, deemed by the commissioner to be available for payment of losses and claims at values to be determined by him."

This subsection and succeeding sections of the chapter dealing with assets *were not added to the Alabama Code until 1971* some six years after the "valuation" in question! Section 745, Act No. 407, Acts of Alabama 1971, p. 707.

[3] It was Moody's witness, former Commissioner Ussery who pointed out on cross examination that defense exhibit 6 (relied on by petitioner to support the allegation that the "valuation" was made by the Alabama official, page 3 of Petition) did not contain the customary certificate in that the Department certified verification and evaluations of the *liabilities only* (see Appendix A-9).

> "While the suit did not directly challenge the actions of the Alabama Department of Insurance, the claims in the end invited the federal courts to determine that those actions were wrong." (Petition page 13)

Moody's arguments that the Court of Appeals' decision jeopardizes the independence of state governments stands federalism on its head. Perhaps the most immediately telling point in demonstrating the absurdity of his contention is that the *plaintiff* in this action was the Alabama Commissioner of Insurance, the very state official whose "independence" Moody claims is being invaded by the suit. To say that the acceptance of the Receiver's position by the courts below fails to show deference to the Alabama Commissioner of Insurance is the height of illogic. Suits such as this one by the statutory Receiver, as expressly authorized under state law, complement, rather than interfere with, state regulation of insurance companies.

This action did not put the federal court in the position of "collaterally attack[ing]" any determinations of the Alabama Department of Insurance, nor of "second-guessing the decisions of state administrators." Moody was not "found liable for decisions made by state agencies." He was found liable for his own fraud, gross negligence and breach of fiduciary duties, including, but no limited to, the temporarily successful fraud on the Alabama Department.

Moody's argument is analagous to one obtaining Securities and Exchange Commission approval of a filing and thereafter maintaining that a 10b-5 action is barred. Moody in effect states having obtained approval of the Alabama Insurance Department by fraud, any further actions are barred.

Under the laws of Alabama the doctrine of estoppel does not ordinarily operate against the State or its agencies. *Marsh v. Birmingham Board of Education*, 349 So. 2d

34 (Ala. 1974). Further, and most important, one who invokes estoppel must have in good faith been ignorant of true facts at the time the representation was made to him and at the time he acted on it; he must also show he acted with diligence to learn the truth. *Goforth v. Hallmark Pools*, 393 So. 2d 989 (Ala. 1981).

The Commissioner of Insurance as Receiver of Empire brings this action based on Moody's fraud in fixing a valuation of $14.2 million on the trust interest assigned to Empire. The actions of all insurance departments, stockholders, directors and other interested parties were predicated on an assumption that Moody had an "appraisal" by a national accounting firm. This is an issue of fact, fact determined by a jury based on overwhelming testimony and written documents introduced into evidence. It should not be disturbed.

II.
THE COLLATERAL ATTACK STATE LAW

Moody next urges to this court that the Court of Appeals has allowed in effect a collateral attack on a judicial holding of a state administrative agency. Nothing could be further from the fact.

The Commissioner of Insurance of Alabama did not make a collateral attack. He made a frontal attack. A direct attack on the false and fraudulent valuation of the principal asset of Empire Life Insurance Company of America. That attack was made in an Alabama state court. Moody was there. Moody was a party.[4]

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[4] In fact, during trial of this case Moody's counsel conceded to the trial court that the valuation by the Alabama receivership court was res judicata and that Empire was insolvent on June 29, 1972.

> "Moody did not contest the finding of insolvency and made no appeal from the trial court's ruling of June 29, 1972. Apparently Moody accepted the insolvency finding because when the receiver obtained approval from the lower court to solicit reinsurance proposals Moody was one of those who submitted plans for the rehabilitation of the company. Moreover, Moody made no issue of Empire's insolvency during the lengthy hearing in April, 1974, when the issue of rehabilitation or reinsurance was aired." *Moody v. State ex rel. Payne*, 344 So. 2d 160, 164, (Ala. 1977).

The collateral attack, if it exists is the attempt by Moody to now attack the holding of the Alabama courts in fixing the value of the trust by ignoring it and trying to revive the 1965 approval. He seeks to give it some semblance of validity, stability and respectability through a quasi judicial theory.

But it doesn't exist. Empire was simply allowed to carry the value of the trust interest at $14 million based on documents, annual statements, letters and other representations and assurances that there was a "valuation" by a national accounting firm and actuaries at the higher value. In fact there was not. The "valuation" was a fraud, and Moody did it.

III.
BANGOR PUNTA

Moody's reliance on *Bangor Punta Operations, Inc. v. Bangor and Aroostock Railroad Company*, 417 U.S. 703 (1974) is best answered by the considered opinion of the Fifth Circuit (A-16 through A-18). Quite simply put, *Bangor Punta* is not appropriate to the case in point.

The instant lawsuit began in March of 1972. The com-

pany went into receivership June, 1972. Bids for reinsurance were not taken until late 1973. The reinsurance itself did not take effect until 1975 and the receiver by the express terms of the reinsurance agreement, held out this cause of action as an asset for the benefit of all creditors.

Protective Life bought policyholder liabilities far exceeding the accompanying assets. In return, they demanded and received certain moratorium benefits on policies assumed together with certain benefits on the proceeds of this litigation. A windfall simply does not exist.

CONCLUSION

This suit is a suit for damages with common law causes of action involving no national or federal questions. It was correctly decided in the courts below.

Based on the foregoing, the Petition for writ of certiorari should be denied.

Respectfully submitted,

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On Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

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REPLY BRIEF FOR PETITIONER

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---

REPLY BRIEF FOR PETITIONER

In our petition, we took the position that the courts below improperly chose to substitute their judgment regarding valuation of insurance-company assets for the judgment of a state insurance commissioner. Petition at 8-18. In addition, we noted that the court of appeals wrongly imposed a rule of its own making to govern a state-law claim rather than identifying and adhering to state law. Petition at 18-23. Respondents offer little or no answer to these points, largely choosing to argue that the facts support the judgment below.[1] We make the following points in reply.

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[1] In presenting their version of the facts, respondents rely far more on rhetoric than on citation to the record. See Brief in Opp. at 4-6. Contrary to their assertions, petitioner did present substantial evidence regarding the issue of the valuation, including testi-

1. Mindful that this Court does not sit to review questions of fact, respondents claim that our petition seeks merely to challenge findings of fact by the jury. That argument completely misses the point. Our position is not that the jury incorrectly decided the issue of valuation but that it should not have been allowed to decide the issue at all. The valuation of insurance-company assets is not the business of a federal court. See Petition at 8-18.

It does not improve respondents' argument to salt it with claims that the valuation was rendered ignorantly or as the result of misconduct. To begin with, it is well-established that such allegations are insufficient to justify collateral attacks on agency determinations. See, e.g., *Bolton* v. *Coats*, 514 S.W.2d 482 (Tex. Civ. App. 1974); *Jay* v. *State*, 15 Ala. App. 255, 73 So. 137 (1916). See also *Providence Rubber Co.* v. *Goodyear*, 76 U.S. (9 Wall.) 788 (1870). Moreover, an exception of this sort would make formal state action meaningless whenever a plaintiff could offer belated testimony suggesting that the state officials were misinformed. As this Court said only a few years ago, in discounting testimony from state officials that agency approvals had been given " 'unwittingly' or only because the departments were unfamiliar at the time" with particular types of agreements: "[W]e do not think this after-the-fact testimony from single officials should outweigh the formal, official approval rendered under the names of the commissioners after opportunity for full review." *United States* v. *Consumer Life Insurance Co.*, 430 U.S. 725, 751 n.36 (1977).[2]

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mony from Empire officials and Frank Ussery, an Alabama Commissioner of Insurance. See, e.g., T. 1427-97, 1573-1617. Moreover, as we discuss below, their charges of "fraud" depend on the predicate that the trust was overvalued, a predicate that assumes the propriety of having a federal jury make its own after-the-fact determination of the trust value. Our petition, of course, is based on the belief that such an assumption is wrong as a matter of law.

[2] The Court also noted that "this formal approval withstood careful triennial audits." *Id.* at 751 n.36.

This case would be a particularly inopportune one in which to invent a contrary rule. Here, the only misconduct alleged, in respondents' own words, is "allowing an under capitalized life insurance company to embark upon an aquisition [sic] program by virtue of a paper surplus of $14 million established without appraisal or verification when Empire was receiving between $165,000 to $250,000 income from the trust and did not have true surplus asset resources with which to withstand the risk of such growth and attendent [sic] expenses." Brief in Opp. at 5. But the questions whether Empire was "undercapitalized" or had a "paper surplus" are precisely the questions that were before the Commissioner when he decided to value the trust asset at the $14.2 million figure. If the determination of the Commissioner is deemed controlling, as we submit that it should be, then the claims of undercapitalization and the like disappear by their own hypothesis.[3]

Whatever respondents might prefer, an improper failure to abstain cannot be excused by touting the ultimate decision on the merits. It is possible, of course, that a federal judge or jury may have a surer feel for the value of a reserve asset than a state insurance commissioner, just as they might make a better judgment about the propriety of a drilling order (*Burford* v. *Sun Oil Co.*, 319 U.S. 315 (1943)), or the need for continuing railway service (*Alabama Public Service Commission* v. *Southern Ry. Co.*, 341 U.S. 341 (1951)), or the reasonableness of automobile insurance rates (*Allstate Insurance Co.* v. *Sabbagh*, 603 F.2d 228 (1st Cir. 1979)), or the merits of an exclusionary clause in an insurance policy (*Smith* v. *Metropolitan Property & Liability Ins.*, 629 F.2d 757 (2nd Cir. 1980)). But the likelihood is sufficiently low,

---

[3] Not even respondents have suggested that the raw figures submitted to the Commissioner were in any way inaccurate. Their complaint is simply that, based on those figures, a value of $14.2 million was excessive. Brief in Opp. at 5.

and the intrusion on state regulation sufficiently grave, that this Court and various courts of appeals have required the federal courts to abstain. The same course should have been followed here.[4]

2. Apparently seeking to evade both the abstention and federal-common-law arguments, respondents assert that "[t]here was no evidence of any 'valuation' made by the State of Alabama." Brief in Opp. at 5. The assertion is demonstrably false.

First, the law is unequivocal on this point. In 1965, when the valuation of $14.2 million was set, Alabama law provided that "[t]he superintendent of insurance [later called the Commissioner] shall allow to the credit of an insurance company, in the account of its financial condition, on such assets as are or can be made available for the payment of losses in Alabama." 28 Ala. Code § 61 (1959). When the Code was revised in 1971, the Commissioner was similarly charged to admit "[o]ther assets, not inconsistent with the provisions of this section, deemed by the commissioner to be available for the payment of losses and claims, at values to be determined by

---

[4] Although respondents stress that "the plaintiff in this action was the Alabama Commissioner of Insurance," Brief in Opp. at 8, they neglect the nominal nature of his appearance. This omission is particularly noteworthy because, in the district court and court of appeals, respondents took exactly the opposite position. For example, counsel for the Receiver insisted at trial: "I do not represent the Department of Insurance of Alabama." T. 78. Similarly, on appeal, respondents declared: "When Moody increased the value of the Trust and sought approval from the Insurance Commissioner of Alabama, he was dealing with a state regulatory agency, whose responsibility was to the insurance public, however in the instant case, as receiver of Empire he is for all purposes and intent the corporation itself. See *Carpenter* v. *Pink*, 124 S.W.2d 981 (Tex. 1939). *The instant lawsuit thus is brought not by the Insurance Commissioner, but by the corporation on behalf of its creditors, stockholders and policyholders. Cotton* v. *Republic National Bank of Dallas*, 395 S.W.2d 930 (Tex. 1965)." Appellees' Brief at 64 (emphasis added). Their current position thus has proved unpersuasive even to themselves.

him." Ala. Code § 27-31-1 (13) (1977). Under either provision, it is evident that the Commissioner must ultimately decide whether an asset is "available for the payment of losses" and, if so, in what amount.

Second, the record in this case leaves little doubt that the Alabama Commissioners actively exercised that power. In 1965, for example, when Empire submitted a letter from an actuary showing a range of values (as of December 31, 1964) from $7,795,200 to $14,403,200 to $29,499,200, DX 64, the Alabama Commissioner declined to accept the higher figure and, in fact, reduced the middle figure by approximately $200,000 to the admitted value of $14,213,440.[5] The Empire Examination Report (on which respondents seek to rely (Brief in Opp. at 7, n.3) likewise notes that, in the following year, a "decision was given by the Superintendent of Insurance of the State of Alabama" allowing the value to be carried at $14,213,440 subject to requirements about insurance and collateral. DX 6, at 57. The Examination Report then directed creation of a liability account under the title "Security Valuation Reserve" that effectively lowered the net value of the trust asset to $13,528,000. In 1968, Commissioner Ussery, according to his own testimony, independently decided upon a requirement that Empire establish a reserve account, to be increased by $430,000 a year, to reflect the declining value of the life interest as the life tenant grew older. T. 1583-1586. Finally, in 1972 Commissioner Bookout required the trust interest to be carried at a value of $4,250,000. This course of events hardly reflects a passive role for the state Commissioner.[6]

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[5] As we noted in our Petition (at 3 n.3), the court of appeals gives the mistaken impression that the Commissioner reflexively accepted a figure submitted by the company. In fact, the Commissioner settled upon his own figure, an amount somewhat less than the second highest number submitted by the company.

[6] In light of this direct involvement in the setting of valuation figures, respondents' analogy to a SEC filing is off the mark. See Brief in Opp. at 8.

Third, we note that respondents contradict their own argument. For, while deprecating the authority of the Commissioner in one breath, at the same time they insist upon the finality of his valuation in 1972 that led to Empire's insolvency. Brief in Opp., at 9-10. As respondents appear to admit, it would have been wholly improper for Empire to have carried the trust interest at $14,213,440 after the Commissioner had held its value to be $4,250,000. It would have been equally improper for Empire (or petitioner) to have gone to federal court to seek a higher valuation or to hold the Commissioner liable for the resulting insolvency. The correctness of such determinations is not a matter for federal interference, an observation that applies to the 1965 valuation as well as to the 1972 one.[7]

3. It is an oddity of respondents' brief that, while belaboring points not raised in our petition (e.g. equitable estoppel), see Brief in Opp. at 6-9, it is virtually mute on issues that were raised. Respondents thus address the issue of abstention only indirectly and the issue of federal common law not at all. We think their silence merits further attention.

The basic issue here is whether a federal court or a state official should make the controlling decision regarding valuation of assets held by insurance companies. At trial, respondents took the position that "the approval of the Department has no relevancy" (T. 1582), a position that they seem to track in the Brief in Opposition. Brief in Opp. at 7-8. Yet, if that position were accepted, the decisions of state insurance regulators would be routinely voidable whenever a federal court, often acting on

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[7] Although respondents note that petitioner did not appeal the 1972 determination, which caused the company to become insolvent, Brief in Opp. at 9-10, that argument is a red herring. Petitioner is not contending that the federal court should have overturned the 1972 valuation; rather, he is saying that it should not have overturned the 1965 one. See Petition at 11.

the basis of hindsight, reached a different conclusion.[8] Even if that were a desirable result, which it is not, it would mark a radical change in the states' authority over insurance matters. See 15 U.S.C. § 1011 ("the continued regulation and taxation by the several states of the business of insurance is in the public interest").

It is not surprising, therefore, that respondents cite no cases allowing the federal courts to embrace collateral attacks on state insurance decisions. Nor do respondents even explain why it would be a good idea. If Alabama courts wish to recognize such a cause of action, aggrieved persons will be able to obtain all appropriate relief without the interference of a federal court. On the other hand, should the Alabama courts hold that such collateral attacks are impermissible, then it would be especially inappropriate for the federal courts to exact damages on the ground that state determinations were erroneous. See *Construction Aggregates Corp.* v. *Rivera de Vicenty*, 573 F.2d 86, 96 (1st Cir. 1978) (federal court, sitting in diversity, cannot entertain cause of action not recognized under state law). The role of the federal courts is, at best, superfluous, and, at worst, distorting.

Respondents also present no real defense of the inclination of the court of appeals to fashion federal common law. Although respondents do suggest that state law denies the Commissioner final authority over valuation of insurance assets, that suggestion is plainly wrong (see pages 4-5, *supra*) and, in any event, is unresponsive to the problem. Even if we concede that federal common law at times may fortuitously coincide with state law, it is the responsibility of the federal courts to seek out state

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[8] The importance of hindsight is not merely theoretical. In this case, for example, the court of appeals relied on the earnings history of American National Insurance Co. (the principal trust asset) *after 1965*. Pet. App. at A-22. The Alabama Commissioner obviously could not have considered that information in making the 1965 determination.

law directly, not to rely on the law of averages. The failure to do so is a serious concern in any case, regardless of the actual result. When, as here, the federal rule reverses state law, the affront to *Erie* principles is even more severe.

CONCLUSION

The petition for a writ of certiorari should be granted.

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OCTOBER TERM, 1982

SHEARN MOODY, JR.,
Petitioner,

v.

DAVID C. MEYERS, *et al.*,
Respondents.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

MOTION FOR LEAVE TO FILE BRIEF OF AMICI CURIAE, AND BRIEF OF AMICI CURIAE, THE AMERICAN CONSERVATIVE UNION AND THE CONSERVATIVE CAUCUS, INC., IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI

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MOTION FOR LEAVE TO FILE BRIEF OF AMICI CURIAE, THE AMERICAN CONSERVATIVE UNION AND THE CONSERVATIVE CAUCUS, INC., IN SUPPORT OF PETITIONER

The American Conservative Union and The Conservative Caucus, Inc., hereby respectfully request leave to file the attached Brief of Amici Curiae in support of the Petition for Writ of Certiorari in this case.

Amicus American Conservative Union is a non-profit, tax-exempt corporation organized and existing under the

laws of the District of Columbia. It has forty-three state affiliates, and more than 325,000 members, contributors, and supporters throughout the United States whose interests the ACU represents. The ACU, among other goals, is concerned with lessening of the burdens of government and promoting the principles of federalism, including the maintenance of the proper relation between the federal courts and the governmental agencies of the fifty states. The ACU also supports the principles of the free enterprise system, including a rational system of corporate governance and responsibility which will not unduly impede the continued development of our system of private enterprise.

Amicus Conservative Caucus, Inc., is a non-profit organization founded in 1974 to advance various conservative policy objectives. With over 400,000 supporters, the Conservative Caucus is one of the largest conservatively oriented "grass roots" lobbying organizations in the country. The Conservative Caucus is currently engaged in a major project to develop and promote legislative proposals for reform of the federal judicial system. This project focuses, *inter alia*, on issues relating to the relationship between federal and state courts. Amicus is therefore highly interested in the issues presented by the Petitioner.

Accordingly, amici respectfully request that they be permitted to state their views on the merits of the Petition. Amici will show that the decision of the Fifth Circuit in this case is an impermissible collateral attack on the lawful determinations of a state Insurance Commissioner, of a type prohibited by the laws of the states concerned. Authorities and policy arguments not contained in the Petition, but relevant to the issues presented therein, will be discussed. The brief will also show that the Fifth Circuit's decision imposes corporate fiduciary

liability based upon principles which are contrary to state law and without basis in policy.

Respectfully submitted,

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STATEMENT

Amici adopt the statement of Petitioner. Pet. 2-6.

INTEREST OF AMICI

The interest of Amici is set forth in the foregoing Motion.

SUMMARY OF ARGUMENT

The decision of the Fifth Circuit Court of Appeals, if allowed to stand, will seriously undermine the ability of state administrative agencies to regulate matters which are entrusted to them, by allowing agency determinations to be collaterally attacked in subsequent federal court proceedings. In the exercise of their business judgment, corporate officers and directors of regulated companies must be able to rely upon the adjudications of the agencies which regulate their companies' affairs. If the determinations of these agencies—which are binding on the companies and their officers and directors during the time they are in effect—can later be disregarded by the federal courts, there will be no rational basis for business planning and a wholly unwarranted increase in personal liability of officers and directors will result. The sole basis upon which the Fifth Circuit predicated liability involved just such a collateral attack.

The Court said that "there was only one wrong complained of and proved: the manipulation of the life interest leading to fatal undercapitalized acquisition * * *." Pet. App. 27. Yet the valuation of the life interest of which the Fifth Circuit complains was placed on it by the Alabama Insurance Department, and the subsequent acquisitions of other insurance companies in reliance on that valuation were also approved by the Department. The Fifth Circuit, in disregarding these facts, has rendered the actions and findings of the Alabama Insurance Department nugatory. Under the rules of law prevailing in Alabama and Texas, as well as in other states and throughout the federal system, it is clear that a binding adjudication of a state agency is not subject to collateral attack in the form of a suit for damages. But precisely that has occurred in this case.

The Alabama Insurance Department has a duty to make an independent decision regarding the affairs of the insurance companies which it regulates, and in this case it did so. There are no permissible legal grounds for a collateral inquiry into the merits of that decision. Though the basis for the Fifth Circuit's disregard of the Department's findings is unclear, nothing in the case remotely approaches extrinsic fraud, which is the only basis under state law for a collateral attack.

When a regulatory agency has made a decision which is binding upon the regulated company, the officers and directors of that company must be able to rely upon it without fear of liability. It is well established that corporate directors may rely upon the opinions of counsel, accountants, and other experts in making corporate decisions. In the area of insurance, there should be no one more expert than the public officials charged with making determinations regarding the assets, liabilities, and other financial affairs of insurance companies. The trend in state and federal decisions pertaining to fiduciary responsibilities of corporate officers and directors has been to increase their ability to rely upon impartial, outside advice. The argument of the Fifth Circuit—that a company cannot "delegate" its responsibility to value its assets—has no basis in law or reason. Alabama and Texas law expressly place on insurance department officials the duty to value the assets of insurance companies. This is no more than a recognition of the established rule that such delegation comes from the legislature, not from the regulated company. Because the legal linchpin of the Fifth Circuit's decision is a principle which has no basis in policy, and runs directly counter to applicable state law, certiorari should be granted and the decision reversed.

ARGUMENT

I. THE DECISION OF THE FIFTH CIRCUIT IS AN IMPERMISSIBLE COLLATERAL ATTACK IN VIOLATION OF STATE LAW WHICH USURPS THE POWER OF THE STATES TO ADMINISTER THEIR INSURANCE LAWS.

Stripped to its essence, the contention of the Receiver in this case is truly remarkable. It is unquestioned that when Shearn Moody, Jr. was an officer and director of the Empire Life Insurance Company, and the company requested the Alabama Insurance Department to revalue an asset, the Department did in fact do so, placing on it a valuation close to one value submitted by Empire. That valuation was confirmed by a subsequent Superintendent of Insurance. Acquisitions of other insurance companies—in reliance upon the Superintendent's valuation—were also approved by the Department. *See* Pet. 14 (giving citations to the record). Now the present Commissioner contends that those determinations made by his predecessors were erroneous, and that Moody should be held personally liable for actions taken in reliance thereon during the time the determinations were in effect.

A lawsuit which predicates liability upon the theory that the life interest was not worth what the Department of Insurance said it was, and that the acquisitions should not have taken place despite approval by the Department of Insurance, is clearly a collateral attack. Liability in this case was predicated only on state law, and on most questions the Fifth Circuit applied the law of Texas. Pet. App. 19, 26. The Texas courts have applied the following definition: "A collateral attack on a judgment is an attempt to avoid its binding force in a proceeding not instituted for such purpose * * *." *Akers v. Simpson*, 445 S.W.2d 957, 959 (Tex. 1969); *Hogan v. City of Tyler*, 602 S.W.2d 555, 558 (Tex.Civ.App.—Tyler, 1980); *Kaphan v. Fidelity & Deposit Company of Maryland*, 564 S.W.2d 459, 462 (Tex.Civ.App.—Houston [1st Dist.], 1978).

This definition has also been followed in the federal courts. In applying the rule against collateral attacks on prior determinations of a state agency, a District Court defined collateral attack as "an attempt to avoid, defeat, or evade a judgment or deny its force and effect in some judicial proceeding not provided by law for the express purpose of reviewing it." *United Merchants & Manufacturers, Inc. v. South Carolina Electric & Gas Co.*, 113 F.Supp, 257, 262 (W.D. S.C. 1953), *aff'd*, 208 F.2d 685 (1953). The Court stated that "if the action has an independent purpose and contemplates some other relief or result, the action is collateral." *Id.*

Without question, the instant proceeding was not instituted for the purpose of reviewing the decision of the Alabama Insurance Department. Instead, it has an "independent purpose" and "contemplates some other relief or result," namely, recovery of damages in a civil suit. As such, it is collateral.

It is equally clear that the laws of both Texas and Alabama prohibit collateral attacks on the quasi-judicial determinations of administrative agencies. *See* cases cited in Pet. 13, 18 n.19. The Texas and Alabama rule is in accordance with the general rule prevailing throughout the country. Both Texas and Alabama provide specific, statutory procedures which are the sole means for a *direct* challenge to rulings by the Department of Insurance. Pet. 15. Any suit not following those procedures is collateral. According to Professor Davis, proceedings that courts have classified as collateral include "suits against private parties for damages" and those "challenging the validity of prior administrative action." 2 K. Davis, *Administrative Law Treatise* § 18.10 (1958).

Until now, the federal courts have been scrupulous in refusing to entertain collateral attacks on state administrative rulings. Cases in which a state Superintendent of Insurance has attempted to retroactively impose liabil-

ity for a corporation's activities which had been approved by his predecessors are understandably quite rare. But when this has been attempted, the federal courts have rejected it out of hand. The case most similar to this one on its facts is probably *Modern Woodmen of America v. Casados*, 17 F.Supp. 763 (D. N.M. 1937). In that case, the Superintendent of Insurance was attempting to collect a premium tax for past years from a corporation which had previously been determined to be a fraternal society, and thus exempt from the tax. A three-judge panel held that the prior administrative adjudications were not subject to collateral attack. The opinion is worth quoting at some length:

> Each year plaintiff was determined to be a fraternal society and licensed as such. No one throughout the years has challenged such determination. No direct attack has ever been made on any such orders of the Superintendent of Insurance. The attack here is purely collateral. What the present head of the insurance department alleges is simply that the determinations of his predecessors were erroneous, and asks this court to disregard them. This we cannot do. Where a statute reposes the decision of a question of fact in an administrative officer or body, his decision thereon, unless set aside by a court of competent jurisdiction in an appropriate proceeding, is binding on the courts in subsequent litigation. * * *
>
> Determinations of such administrative officers are generally spoken of as adjudications. Whether the term is accurate is not material; administrative officers are not judges, but in determining fact questions and entering orders based thereon, they perform judicial functions. The label is not important; the fact remains that such determinations are binding because the legislature has reposed in such officials the power to determine such facts, and orders based thereon are conclusive until they are set aside or reversed in appropriate proceedings. They are not open to collateral attacks. *Id.* at 766.

The *Modern Woodmen* case also involved a question as to sufficiency of the company's reserves. The Court's decision on reserves parallels the issue of valuation of the life interest in the present case:

> Whether plaintiff's reserves are sufficient is a question confided to the decision of the Superintendent of Insurance and his actuaries. For years, that official has approved policies issued by plaintiff with provisions for reserves, their application or withdrawal. Implicit in such approvals is a finding that the reserves met the statutory standard. Such approvals may not be collaterally attacked * * *. *Id.* at 768.

In a case in which virtually the same facts were present, a state court also applied the same rule. *State ex rel. Biel v. Royal Neighbors of America*, 44 N.M. 8, 96 P.2d 705 (1939). In holding that a determination by the Superintendent of Insurance could not be collaterally attacked, the Court noted that *for the years in question* the agency's determination is conclusive upon the taxing authorities "and all others." *Id.* at 709.

This Court, in a case applying Texas law, has affirmed that the determination of a state regulatory agency cannot be collaterally attacked in a suit against a private party for damages. In *Steele v. General Mills, Inc.*, 329 U.S. 433 (1947), the Court considered whether a motor carrier could charge the rates established by the Texas Railroad Commission, despite a contractual agreement entered into by the carrier to charge a lesser rate. The shipper set up numerous defenses, including a denial that the carrier's rates were governed by the Commission's prior rate orders. The District Court held that "Texas law barred respondent from any collateral attack on the validity of the orders", and the Supreme Court agreed. This Court noted that the determination that the orders were not subject to collateral attack was "well buttressed by state statutes and court decisions." *Id.* at 442. Be-

cause the Fifth Circuit had allowed the shipper to set up one defense which would have prevented enforcement of the rates established by the Commission, the Supreme Court reversed. The Court noted that jurisdiction was based upon diversity, and that such a defense "would result in applying a rule of law in the federal courts different from the rule we believe has been applicable in the state courts." *Id.* at 443. An argument was made in the case that allowing the Fifth Circuit's decision to stand would "impair the integrity of the State's regulatory system." *Id.* at 442. Mr. Justice Black, writing for a unanimous Court, stated that "[w]hether the Circuit Court of Appeals' judgment does undermine the transportation policy of Texas is a question of such importance that we granted certiorari to review the case." *Id.* Amici respectfully submit that the Fifth Circuit's decision in this case would equally undermine the integrity of the states' insurance regulatory systems, and that certiorari should be granted.

The lower federal courts have been equally vigilant in rejecting collateral attacks on state regulatory rulings. In *United Merchants & Manufacturers, Inc. v. South Carolina Electric & Gas Company*, 113 F.Supp. 257 (W.D. S.C. 1953), *aff'd*, 208 F.2d 685 (1953), the plaintiff brought a damages action for fraud and deceit against a utility company. In doing so, it sought to avoid the effect of certain rate rulings which had been made by the state Public Service Commission, alleging that the defendants had procured them by fraud. The Court held that the rates must be considered binding absent a direct challenge in state court. They could not be collaterally attacked in federal court.

The case of *Construction Aggregates Corp. v. Rivera de Vicenty*, 573 F.2d 86 (1st Cir. 1978), is entirely on point. In that case, the First Circuit refrained from deciding issues pertaining to rates established by the Puerto Rican State Insurance Fund. The Court doubted

whether the federal courts would even have jurisdiction, and stated:

> The laws of the Commonwealth provide for review of rates set by the Insurance Fund in the Industrial Commission, with direct review of the decision of the Industrial Commission in the Supreme Court of Puerto Rico. * * * Construction has not cited any statute or authority granting to the Puerto Rico courts jurisdiction to entertain an attack on an Insurance Fund rate in any other manner. If the laws of Puerto Rico do not recognize a cause of action permitting a collateral attack on these rates, a federal court in the exercise of its diversity jurisdiction would be unable to entertain any such claim. *Id.* at 96.

The Court went on to conclude that, even if there was jurisdiction:

> The rate-making process of the Insurance Fund is an area of intensely local interest, and judicial review of the process has been centralized in a single court. Intervention by federal courts could disrupt the efforts of the state to develop a coherent rate structure. *Id.*

Accord, *Taylor v. New York City Transit Authority*, 309 F.Supp. 785 (E.D. N.Y. 1970), *aff'd*, 433 F.2d 665 (2d Cir. 1970), "In New York State the determinations of administrative agencies acting in a judicial or quasi-judicial capacity are not open to collateral attack."); *McCulloch Interstate Gas Corp. v. Federal Power Commission*, 536 F.2d 910, 913 (10th Cir. 1976) (applying same principles to federal agencies).

Because of the importance of allowing the states full control over insurance company regulation, the federal courts have given great deference to state insurance department determinations, even when the determination is not a quasi-judicial finding of fact (as it was in this case), but is only a legal interpretation. In *United*

States v. Consumer Life Insurance Co., 430 U.S. 725 (1977), the Internal Revenue Service had assessed deficiencies against a corporation on grounds that it was not a "life insurance company" for federal income tax purposes. Qualification as a "life insurance company" depended upon how a certain liability of the company (unearned premium reserves) was to be treated. For the six years in question, the Supreme Court considered the treatment of those reserves by state insurance departments to be a "compelling" indication. *Id.* at 751. The Court noted that "[t]he insurance departments of the affected States consistently accepted annual reports showing reserves held as the taxpayers claim they should be." *Id.* In confirming the rule that such agency determinations are entitled to "great deference", the Court stated that this "is no less the rule when federal courts are interpreting state law administered by state regulatory officials * * *." *Id.* at 752. In an interesting parallel to the instant case, the Court discounted the testimony by certain insurance department officials from the states in question that the treatment of the reserves was permitted "unwittingly." *Id.* at 751, n.36. The Court rejected the notion that "this after-the-fact testimony from single officials should outweigh the formal, official approval rendered under the names of the commissioners after opportunity for full review." *Id.* Where the question is one of fact rather than law, there is even less justification for permitting a challenge to a state insurance department's determination. *See also Jordan v. Acacia Mutual Life Insurance Co.*, 409 F.2d 1141 (D.C. Cir. 1969) (deference given to interpretation by Superintendent of Insurance of *penal* statute concerning insurance companies).

In applying Texas law, the Fifth Circuit has recognized that even judgments which are plainly contrary to statute are safe from a collateral attack. *Norton v. Austin National Bank*, 557 F.2d 1061 (5th Cir. 1977). In *Norton*, the Fifth Circuit concluded that the judgment

could not be collaterally attacked, stating that "however erroneous [it] may be, [it is] not void." (*quoting Withers v. Patterson*, 27 Tex. 491, 497 (1864)). *Id.* at 1064. Since administrative adjudications are also immune from collateral attack in Texas, the Fifth Circuit had no basis in this case to pass on whether the Insurance Department's determinations were "erroneous."

In permitting the collateral attack upon the Insurance Department's determinations, the Fifth Circuit never provides any explicit statement of grounds upon which those rulings could be attacked. The opinion does contain at least two intimations that the rulings were somehow improperly obtained, but neither is sufficient to set aside an administrative adjudication.

First, the Fifth Circuit opined that Superintendent Houseal "might" have been swayed by considerations of friendship in approving the increased valuation of the life interest, since he was friends with Moody's lawyer and had visited Moody's Texas ranch on several occasions. Pet. App. 8, n.4. It is common knowledge that friendships often exist between regulators and regulated. To permit an agency action to be disregarded on such grounds would bring into question the validity of huge numbers of administrative determinations in every context. To the extent that this forms the basis for the Fifth Circuit's decision, it is wholly at variance with existing law and any concept of rational public policy.

The second ground on which the Fifth Circuit may have relied to vitiate the findings of the Superintendent of Insurance is Moody's alleged failure to disclose a subjective belief that the life interest could not be further transferred. Pet. App. 3. There is no showing that the interest was in fact not transferable, or that the alleged untransferability had any effect on the company's subsequent financial operations. But even if this fact is material from the point of view of proximate cause, which seems extremely doubtful, it is a well-settled rule of law

that quasi-judicial rulings of an administrative agency cannot be overturned on the basis of intrinsic fraud. The case of *Bolton v. Coats*, 514 S.W.2d 482 (Tex.Civ.App.—Tyler, 1974) is exactly on point. In that case, the plaintiff attempted to collaterally attack an order of the Texas Railroad Commission. The Court summarized the plaintiff's contentions, and rejected them:

> [Plaintiff] argues that since there is evidence raising the issue of whether defendants were guilty of fraud in procuring the Railroad Commission's order, defendants are estopped from relying on the order as a shield of liability. Therefore, he argues that defendants are estopped to defend themselves on the ground that his Panola County suit amounts to a collateral attack on the order. *He maintains that upon establishing the issue of fraud in the Panola County suit he would then be able to establish a breach of duty on the part of defendants* to develop the Travis Peak reservoir for oil, *irrespective of the Railroad Commission's finding* that the Travis Peak was a gas reservoir only. We find the proposition to be without merit. While we recognize that in some cases proof of the type of fraud known as extrinsic fraud is held to be sufficient to vitiate an administrative order such as this, neither the pleadings nor the proof shows this to be a case of extrinsic fraud. *The fraud alleged here is the making of false statements* to the Railroad Commission. This type of fraud constitutes intrinsic fraud and for that reason would not be sufficient to vitiate the quasi-judicial ruling of the Commission. * * * Where an administrative agency acts in a judicial capacity on matters within its jurisdiction, as here, the decision made by the agency may not be attacked in a collateral proceeding on the ground of fraud. *Id.* at 487. [emphasis added; citations omitted]

This distinction has been accepted by the federal courts in reviewing agency actions. *United Merchants and Manufacturers, Inc. v. South Carolina Electric and Gas Com-*

pany, 113 F. Supp. 257, 262 (W.D. S.C. 1953), *aff'd*, 208 F.2d 685 (4th Cir. 1953); *see also United States v. Throckmorton*, 98 U.S. 61, 65-66 (1878).

II. UNDER SETTLED PRINCIPLES OF CORPORATE LAW, AN OFFICER AND DIRECTOR IS ENTITLED TO RELY UPON OUTSIDE EXPERT DETERMINATIONS IN THE EXERCISE OF BUSINESS JUDGMENT, AND HE CANNOT BE HELD LIABLE BY VIRTUE OF A POST HOC COLLATERAL ATTACK WHICH DISREGARDS SUCH DETERMINATIONS MADE BY AN AUTHORIZED STATE OFFICIAL.

This case goes to the very core concept of when an officer and director of a corporation may be held liable for breach of fiduciary duty. Here a corporate officer, director, and principal shareholder sought and received a ruling from the appropriate regulatory agency regarding valuation of an asset. He then undertook a program of acquisitions, in reliance upon that asset's valuation, and the acquisitions were also approved. He is now being held liable because the federal courts have seen fit to believe that the agency's determinations were erroneous. A most significant legal issue is therefore presented: is an officer and director of a regulated company justified in relying upon the regulatory agency's express determinations in making business decisions, or does he act at his peril?

Under the "business judgment" rule, it is well settled that an officer and director may take honest risks and not be liable even if the risk turns out badly. The rule has been well-summarized in a noted treatise:

> It is too well-settled to admit of controversy that ordinarily neither the directors nor the other officers of a corporation are liable for mere mistake or errors of judgment, either of law or fact. In other words, directors of a commercial corporation may take chances, the same kind of chances that a man would take in his own business. Because they are given this wide latitude, the law will not hold directors

> liable for honest errors, for mistakes of judgment, when they act without corrupt motive and in good faith, that is, for mistakes which may properly be classified under the head of honest mistakes. And that is true even though the errors may be so gross that they may demonstrate the unfitness of the director to manage the corporate affairs. This rule is commonly referred to as the "business judgment rule," which is generally applied to decisions of executive officers as well as those of directors. 3A W. Fletcher, *Cyclopedia of the Law of Private Corporations* § 1039 (1975).

In formulating a business strategy which may involve risks, upon what information or decisions may the director rely?

The Fifth Circuit held that the standard for fiduciary responsibility should be determined under Texas law. The Texas Business Corporation Act provides an absolute defense when a director has relied upon advice of counsel. Texas Business Corporation Act, art. 2.41(D) (1980). It also provides a defense under certain circumstances when the director has accepted the figures in the company's written financial statements based upon representations by accountants, or has considered assets to be of their book value. Texas Business Corporation Act, art. 2.41(C) (1980). However, no Texas statute or case specifies the standard for the defense of reliance upon expert advice in other contexts. The Model Business Corporation Act, upon which the Texas Act is based, is therefore highly persuasive in determining the common law standard in this case. After stating a general standard of care for directors, the Model Act provides that:

> In performing his duties, a director shall be entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data, in each case prepared or presented by:
>
> (a) * * *

> (b) counsel, public accountants *or other persons as to matters which the director reasonably believes to be within such person's professional or expert competence* * * *
>
> (c) * * *
>
> but he shall not be considered to be acting in good faith if he has knowledge concerning the matter in question that would cause such reliance to be unwarranted. *A person who so performs his duties shall have no liability* by reason of being or having been a director of the corporation. *Model Business Corporation Act Annotated*, 270-71 (2d ed. 1977 Supp.). [emphasis added]

The official Comment to this section describes the scope of permissible reliance upon outside experts:

> As for reliance upon outside advisors, it is intended that there be included not only the professional disciplines customarily supervised by state authorities, such as lawyers, accountants and engineers, but also other fields involving special experience and skills, such as geologists, management consultants, and real estate appraisers. The concept of "expert competence" is intended to embrace a wide variety of qualifications and not be limited to the more precise and narrower recognition of experts under the Securities Act of 1933. *Id.* at 258.

Though there appear to be no Texas cases on point, the defense of reliance upon corporate records or advice of counsel has been recognized in jurisdictions such as New York and Delaware, in which corporate litigation is more frequent. *See, e.g., Graham v. Allis-Chalmers Manufacturing Co.*, 41 Del.Ch. 78, 188 A.2d 125, 130 (1963); *Gilbert v. Burnside*, 13 App.Div.2d 982, 216 N.Y.S.2d 430, 432 (1961). In applying state law, the federal courts have also recognized the need for directors to be able to rely upon independent determinations. Particularly, in the context of derivative suits, the business judgment rule

has been held to be an absolute defense to liability when independent directors, often in conjunction with outside experts, conduct an investigation and the directors rely thereon. *See, e.g., Burks v. Lasker*, 441 U.S. 471 (1979); *Lewis v. Anderson*, 615 F.2d 778, 781-83 (9th Cir. 1979); *Abbey v. Control Data Corp.*, 603 F.2d 724, 727 (8th Cir. 1979); *Maldonado v. Flynn*, 485 F. Supp. 274 (S.D. N.Y. 1980); *Rosengarten v. International Telephone and Telegraph Corp.*, 466 F. Supp. 817, 825 (S.D. N.Y. 1979). These cases have allowed reliance upon such independent determinations even when there has been a conflict of interest on the part of the directors, and even though the committee upon which the directors relied may not have been fully independent. The case for permitting reliance as a defense is therefore much stronger when a corporate director has relied upon a determination by a completely independent body (the state Insurance Department), and when no conflict of interest between the director and the corporation was present.

In fact, the director and the company have little choice in the matter. Under Texas law, the insurance company is required to obey an order of the State Board of Insurance until it is set aside upon a direct appeal. *Cosmo Life Insurance Co. v. State Board of Insurance*, 319 S.W.2d 162, 166 (Tex.Civ.App.—Austin, 1958). Of course, reliance by third parties can never be fully secure until any direct challenges have been completed. As one state court has recognized, where there is a statutory period in which to seek judicial review, "actions taken by other parties in reliance upon such order are taken at the risk that subsequently such order will be judicially disallowed in legal proceedings which are timely filed." *Stewart v. Martin*, 84 So.2d 235, 240 (La.Ct.App. 1955). But once the time for direct review has expired, are corporate officers still required to "act at their peril" in relying on such an order because ten years later the order might be collaterally attacked?

Since the company and its officers are required to obey administrative determinations, they should not be penalized for doing so. The federal courts have been sensitive to protecting persons who have relied on orders of state insurance commissioners during the period they are in effect. In *Preferred Risk Mutual Insurance Co. v. Manchester Insurance & Indemnity Co.*, 467 F.2d 1230 (7th Cir. 1972), an insurance company issued a policy endorsement limiting its risks, despite the fact that the Illinois Director of Insurance had ruled that the endorsement could not be used. The Seventh Circuit stated that "whatever the ultimate determination by the courts on the *prospective* use of the endorsement" in a direct challenge, the ruling must be given effect during the period it was extant. *Id.* at 1234. The court stated that it would be "inequitable" to retroactively apply a later court decision in a way which would injure those who had relied on the determination of the Director of Insurance.

If a director can rely upon counsel, outside experts, and committees, should he not be able to rely upon an expert and binding determination made by a state regulatory agency during the time it is in effect? There can be no doubt of the Insurance Commissioner's expertise. There is no contention that the assumptions upon which the valuation was based were more within Moody's knowledge than within that of the Commissioner. The past earnings of the shares in the life interest were a matter of record. Such matters as the appropriate discount rate to apply, the growth rate, and assumed annual income are essentially predictions about the future, which depend upon a wide variety of factors. They are the sorts of things with which insurance regulators deal all the time, and about which they must be assumed to have special expertise. When that expertise is exercised, and the adjudication binds the company, officers and directors may ignore it only at their own peril. It is perverse to hold that they *follow* it at their peril.

This central legal issue is disposed of by the Fifth Circuit in a footnote, for which no authority is cited. The Court stated:

> Moody also contends that, even if the $14,403,200 revaluation of the life interest were unreasonable, he is not responsible for Empire's subsequent losses because the Alabama Insurance Commissioner approved the revaluation. This contention is spurious. An insurance company may not delegate responsibility for valuation of its assets to a state agency, and the mere fact that an insurance commissioner accepts a company's asset valuation does not immunize the company from liability arising from that valuation. Pet.App. 22.

Petitioner has clearly shown that this unsupported "delegation" theory is contrary to Alabama state law. Pet. 12-13. It is also contrary to the law of Texas. In *Southwest Title Insurance Co. v. State Board of Insurance*, 390 S.W.2d 841 (Tex. Civ.App.—Austin, 1965), the issue in a direct appeal from a finding of the State Board of Insurance was: who had the power to value a major asset of the insurance company—the company itself, or the state agency? The Texas courts clearly stated that only the insurance regulators had that power:

> We do not believe that the [statute in question] permits companies to place their own valuation upon their assets, since other provisions of the Code *require* the Commissioner to examine such companies with respect to solvency, and if a company could fix its own valuation without proof, its capital could be impaired. *Id.* at 845. [emphasis added]

On the same page, the Court referred again to the "duty" of the State Board of Insurance regarding valuation of assets.

This is consistent with the legal theories prevailing in other states. The source of the insurance regulators' power and duty to make regulatory determinations does

not derive from a delegation by the company, but from a delegation of legislative power from the state legislature. *See, e.g., Hardware Mutual Casualty Co. v. Premo*, 153 Conn. 465, 217 A.2d 698, 705 (1966) (delegation of legislative power); *Kueckelhan v. Federal Old Line Insurance Company (Mutual)*, 69 Wash.2d 306, 418 P.2d 443, 452-53 (1966) (delegation by legislature); *Sims v. Manson*, 25 Wis. 2d 110, 130 N.W.2d 200, 202 (1964) (commissioner's powers are entirely statutory). If, as the Fifth Circuit contends, Moody had the power and duty to place his own valuation on the life interest, could he have ignored the decision by the Insurance Department in 1972 to reduce its value to $4,250,000—the decision which threw Empire into insolvency and receivership? If not, it is absurd to contend that the $14.2 million valuation arose from a "delegation" by Moody of his "responsibility" to value the life interest.

CONCLUSION

For the foregoing reasons, the petition for certiorari should be granted.

Respectfully submitted,

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SHEARN MOODY, JR.,
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Respondents.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

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INTERESTS OF THE AMICI CURIAE STATE OF ARIZONA, THE STATE OF GEORGIA, THE STATE OF MISSOURI AND THE STATE OF OKLAHOMA

The States of Arizona, Georgia, Missouri and Oklahoma have a strong interest in the integrity of the federal system ordained by the United States Constitution, and particularly in preventing federal courts from substituting themselves for state lawmaking authorities in the exercise of lawmaking power outside the scope of the powers which have been delegated to the federal government by the Constitution, and which Congress has chosen to exercise. The States of Arizona, Georgia, Missouri and Oklahoma hope to persuade this Court to review and reverse the holding of the court below in order to reaffirm the constitutional limits on the powers of the federal judiciary and the constitutional integrity of the states as lawmaking bodies.

STATEMENT OF THE CASE

Amici hereby adopt by reference the Statement of the Case contained in the Petition for Writ of Certiorari at 2-6.

SUMMARY OF ARGUMENT

The concept of federalism embodied in the United States Constitution requires that the states retain not only titular authority to make decisions on matters not delegated to the central government, but also real power to enforce such decisions. Accordingly, when a federal court substitutes its own motions of sound policy for the applicable positive law that has been enacted by a state legislature or pronounced by a state court, the federal court does more than violate a "technical doctrine of procedure or jurisdiction." Rather, the unwarranted creation of "general federal common law" strikes at "the heart of the relations between the federal government and the states . . . ." C. WRIGHT, HANDBOOK ON THE LAW OF FEDERAL COURTS § 55 at 255 (3d ed. 1976); *see Erie Railroad Co. v. Tompkins*, 304 U.S. 64 (1938).

In this case the Court of Appeals did not simply err in an attempt to apply state law. Rather, it made no attempt to determine what state law provided on the pivotal question in the case. The court brushed aside specific contentions about the statute and decisional law of Texas and Alabama with a single reference to an asserted general principle of law. This principle, however, had been repeatedly rejected by the state courts and state legislatures whose decisions the federal court was bound to apply.

The *only* remedy for the creation of general common law by a federal court in an area outside the authority of the federal government is review and reversal by this Court. In several recent decisions, this Court has reminded lower federal courts that not even the most broadly worded of federal statutes and constitutional provisions are to be construed so as to transform federal courts into courts of general common law. These admonitions will prove to be pointless if federal judges are free to reach whatever results they desire, without fear of Supreme Court review, simply by resorting to the rubric of "interpretation" of state rather than federal law. This

Court should therefore grant certiorari in this case in order to make it clear that *Erie* requires a sincere and thorough effort to discern and apply state law in pendent and diversity cases, even where the positive law of the state contravenes general principles in which the federal judge strongly believes.

I. The holding of the court below was clearly contrary to the applicable state law.

The Court of Appeals held that "there was *only one wrong complained of and proved*: the manipulation of the life interest leading to fatal undercapitalized acquisition." Pet. App. 27 (emphasis supplied). This "manipulation" was held to consist in the petitioner's requesting the Alabama Insurance Commissioner to revalue a life interest owned by the corporation, and his subsequent actions as an officer and director of the corporation in undertaking acquisitions "based on an artificial surplus created by the $14,403,200 revaluation of the life interest." Pet. App. 21. Petitioner contended in the proceeding below, however, that under the applicable law [1] the Insurance Commissioner's ruling on the value of the life inter-

[1] The Court of Appeals seems to have assumed that Texas substantive law applied to most issues in the case. Acknowledging that it was required to follow Texas conflict of laws principles, Opinion at 1458, the court did not in fact inquire into the conflict of law rule that Texas would have applied, but simply applied Texas law (except on the decisive issue in the case, where it neither cited any state law nor alluded to the absence of state authorities—see text at pages 2-5, *infra*). In fact, the opinion in *Gutierrez v. Collins*, 583 S.W.2d 312 (Tex. 1979), suggests that a Texas state court would have applied Alabama substantive law. *Gutierrez* was decided while the appeal in this case was pending, but it should have been followed by the Court of Appeals. *See Vandenmark v. Owens-Illinois Glass Co.*, 311 U.S. 538 (1941). The Court's failure to apply Alabama law would only be relevant if the substantive law of Texas was different from that of Alabama. In fact, had the Court of Appeals consulted *either* Texas or Alabama law on the question whether a state administrative decision can be collaterally attacked in a private suit for damages, it would have been forced to decide for petitioner rather than for respondents. *See* text as pages 2-5, *infra*.

est was not subject to collateral attack in an action for damages. If petitioner had prevailed on this point—*i.e.*, if the courts below had regarded themselves as *bound* by the administrative ruling that the life interest *was* worth $14 million—then petitioner could not have been held "grossly negligent" for acting in accordance with the Commissioners' finding and not with some other and perhaps better evaluation of what the life interest was worth.[2]

In rejecting petitioner's argument against collateral attack on the Commissioner's ruling, the Court of Appeals cited no authority and only the following analysis:

> This contention is spurious. An insurance company may not delegate responsibility for valuation of its assets to a state agency, and the mere fact that an insurance commissioner accepts a company's asset valuation does not immunize the company from liability arising from that valuation.

Pet. App. 22 n.11. This rule, on which the whole case turned, is directly contrary to the rule that would have been applied if the case had been tried in a state court.

The acts of the Alabama Insurance Commissioner are expressly made "quasi-judicial" by statute. Ala. Code § 27-2-31(a) (1975). The Commissioner's statutory duty includes a duty to make an independent appraisal of the

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[2] The court below also stated that the Commissioner "might" have been "swayed by considerations of friendship and obligation in approving the increased valuation of the life interest," Pet. App. 8 n.4, and that during an earlier proceeding than the one on which petitioner's liability was based, petitioner has "failed to disclose his belief that the trust interest was intended to be non-transferable." Pet. App. 26. Neither of these statements, however, was any part of the court's holding, since neither was found to have contributed to "the one wrong complained of and proved." Pet. App. 27. If the court below had regarded itself as bound by the Commissioner's finding that the life interest *was* worth $14 million, neither of these allegations could have created liability on the part of the petitioner, since all damage and all liability in the case were found to have resulted from the life interest being worth *less* than the Commissioner had found it to be worth.

value of the corporation's reserve assets. *Id.* § 27-2-21. This appraisal was made in writing after a hearing at which documentary and testimonial evidence was adduced. Pet. App. 7-8; DX 6. The statute provides an exclusive method for direct attack on rulings of the Commissioner, which must be brought in the circuit court of Montgomery County, Alabama. Ala. Code § 27-2-32 (1975). Similarly, in Texas (the forum state in the proceedings below, whose law the Court of Appeals applied on other questions and presumably would have applied to this question had it deigned to apply state law at all), a direct attack on any "rule, regulation, order, decision or finding" of the State Board of Insurance is subject to review by suit filed in the state district court in Travis County, Texas, "and not elsewhere." Tex. Ins. Code Ann. art. 1.15, § 4 (Vernon 1981). Collateral attacks on agency determinations in private suits for damages are forbidden. *Railroad Commission v. McKnight*, 619 S.W.2d 255 (Tex. Civ. App. 1981); *Bolton v. Coats*, 514 S.W.2d 482 (Tex. Civ. App. 1974); *Railroad Commission v. Marathon Oil Co.*, 89 S.W.2d 517 (Tex. Civ. App. 1935); *Kirby Lumber Co. v. Adams*, 62 S.W.2d 366 (1933). *Accord, State v. Brooks*, 53 So. 2d 329 (Ala. 1951); *Huntsville v. Goodenrath*, 68 So. 676 (Ala. 1915). This rule flows from the quasi-judicial nature of administrative agency determinations and from the need for certainty in business transactions; it does not depend on the soundness of the business judgment, or even on the "good faith," of parties who have treated the administrative finding as though it were true rather than false. Thus, for example, an allegation that a defendant in an action for damages procured an administrative finding by making false statements to the tribunal was insufficient to allow the plaintiff to controvert the finding. *Bolton v. Coats, supra*, 514 S.W.2d at 487. These holdings are incompatible with the rule fashioned by the Court of Appeals in this case to the effect that a state may not "delegate" responsibility for evaluating its as-

sets to a state agency, since the sole effect of this "non-delegation doctrine" was to allow the evaluation to be controverted in a collateral action for damages.

II. The unconstitutionality of the court's decision to fashion a rule contrary to state law was not mitigated by the court's failure to announce its rejection of the state law.

Since *Erie Railroad Company v. Tompkins*, 304 U.S. 64 (1938), this Court has recognized that when a federal court substitutes rules of its own choosing for the statute or decisional law of a State whose sovereignty includes the power to make the law, the court violates the Constitution.

The decision of the court below to create "federal common law" rather than to follow the applicable state law was obfuscated by the court's failure to identify the source of the rule on which it resolved the case. While the court did not attempt to show that its "non-delegation" rule was derived from, or even consistent with, the law of Texas or Alabama, it also refrained from *announcing* that it was applying or creating federal common law. This does not change the nature of the decision. If the Court of Appeals had dealt thoroughly and candidly with the Texas and Alabama statutes and decisions, and then rejected them as "spurious" because they conflicted with a general overarching rule of law to the effect that companies may not "delegate" fact-finding responsibility to state agencies, there would have been no doubt of the court's violation of the Constitution as construed by the Court in *Erie*. Surely there can be no constitutional difference between a candid disavowal of applicable state authorities and a rejection *sub silentio* of the same authorities for the same purpose and to the same effect.

In a sense, federal courts create general federal common law whenever they make incorrect guesses about how state supreme courts would decide the questions of

state law with which they are presented. *See, e.g., Vandenmark v. Owens-Illinois Glass Co.*, 311 U.S. 538 (1941). It would be neither possible nor desirable, however, for this Court to grant certiorari in order to consider every allegation that a federal court had simply *misconstrued* state law. What distinguishes this case—what makes it *at least* as destructive of the constitutional principle of federalism as a candid usurpation of state lawmaking power would have been—is that the court below made no *attempt* to apply state law to the question on which the case turned. If there had been no state statutes or decisions to be found, moreover, the court's failure to allude to its duty to apply state law would be no more than evidence of an unhealthy tendency to forget the role of the federal courts within the federal system; but in this case the court ignored state statutes and decisions that clearly contradicted its holding. Finally, in this case the way in which the court contrived to ignore state law—by rejecting a litigant's references to the enacted and decisional law of a state as "spurious" on the ground that they conflict with a general statement apparently derived from the court's apprehension of "the" law—is the very mode of judicial decisionmaking that *Erie* forbade.

When these three factors are present in a diversity or pendent jurisdiction[3] case—failure to cite state law or to allude to the absence of state authorities, a decision that clearly contravenes state law, and an apparent resolution of the state law question by reference to an asserted general principle of law—the decision partakes of all the evils that are characteristic of "federal general common law," whether or not the decision describes itself as a federal common law decision. Decisions such as the one rendered by the court below meet all the criteria by

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[3] The court below did not find it necessary to determine whether its authority to decide state law questions was based on diversity jurisdiction or on pendent jurisdiction. In either case a federal court's obligation is to follow the decisions of the state courts.

which impermissible federal common lawmaking is commonly characterized:

1) When different rules are applied in state and federal courts respectively—regardless of whether the federal courts admit they are applying different rules, and assuming only the "[p]ersistence of state courts in their own opinions on questions of common law," *Erie*, *supra*, 304 U.S. at 74—there will be a lack of uniformity in the law and a corresponding uncertainty surrounding commercial transactions.

2) Similarly, although diversity jurisdiction "was conferred in order to prevent apprehended discrimination in state courts against those not citizens of the State," application of different substantive rules in federal courts introduces "grave discrimination by non-citizens against citizens" by making "rights enjoyed under the unwritten 'general law' vary according to whether enforcement [is] sought in the state or federal court," and giving the power of selecting the forum (and hence the law) to the non-citizen. *Id.* at 74-75.

3) Whether an error results from a wilful rejection of the court's duty to apply state law or from a *sub silentio* rejection of state law in favor of an asserted general principle has no bearing on whether the error is "outcome-determinative." *See Guaranty Trust Company of New York v. York*, 326 U.S. 99 (1945). In this case the result reached by the courts below could not have been reached if the courts had followed the Texas and Alabama rule against collateral attacks on administrative rulings in private suits for damages, rather than the contradictory general principle formulated by the Court of Appeals. See pages 2-5, *supra*.

4) Nor is this issue within one of the "narrow areas" in which the federal courts are "free to develop a common law" absent a delegation from Congress pursuant to a constitutional grant of federal power. These areas in-

clude "those concerned with the rights and obligations of the United States, interstate and international disputes implicating the conflicting rights of States or our relations with foreign nations, and admiralty cases." *Texas Industries, Inc. v. Radcliff Materials, Inc.*, 451 U.S. 630, 641 (1981) (footnotes omitted). *See generally Clearfield Trust Co. v. United States*, 318 U.S. 363 (1943); *Illinois v. Milwaukee*, 406 U.S. 91 (1972); *Fitzgerald v. United States Lines*, 374 U.S. 16 (1963). One danger flowing from an attitude among federal judges that they ought to formulate general principles of law to govern disputes between private parties outside these specialized areas is that the federal courts will then pay insufficient attention to the development of guidelines to determine when it *is* appropriate to apply or create federal common law. *See* Friendly, *In Praise of Erie—And of the New Federal Common Law*, 39 N.Y.U. L. Rev. 383 (1964). This danger is aggravated rather than alleviated when a federal court creates federal common law without acknowledging (and perhaps even without quite knowing) that it is doing so.

5) The outstanding characteristic of the general federal common law prior to *Erie* was the theoretical premise from which it proceeded: that there is "a transcendental body of law outside of any particular state but obligatory within it unless and until changed by statute." *Black and White Taxicab Company v. Brown and Yellow Taxicab Company*, 276 U.S. 518, 533 (1928) (Holmes, J., dissenting). In *Swift v. Tyson*, 16 Pet. (41 U.S.) 1 (1842), for instance, the Court found it "necessary . . . to express our own opinion of the true result of the commercial law upon the question now before us," notwithstanding the New York decisions that had already addressed the question. *Id.* at 19. The more firmly the judges became convinced that the commercial law was an objectively ascertainable set of principles (like "a brooding ominpresence in the sky," *Southern Pacific Railroad Co. v. Jensen*, 244 U.S. 205, 222 (1917) (Holmes, J.)), how-

ever, the more likely it became that the "general law" would amount to "little less than what the judge advancing the doctrine thinks at the time should be the general law." *Baltimore & Ohio R.R. v. Baugh*, 149 U.S. 368, 401 (1893) (Field, J., dissenting). This theoretical premise and this style of decisionmaking were also the premise and the style of the court below. The Court of Appeals did not find it necessary to inquire into state law on the question because it felt *sure* that petitioner's argument was "spurious." Pet. App. 22 n.11. The argument was "spurious" because it conflicted with a general principle in which the court obviously believed quite strongly. *See id.* This approach to decisionmaking is precisely the approach taken in *Swift* and declared unconstitutional in *Erie*. The error of the court below was to base the petitioner's liability on a principle imported from a source other than (and, as it happens, hostile to) the statute and decisional law of Texas and Alabama. "But there is no such body of law. The fallacy and illusion . . . consist in supposing that there is this outside thing to be found." *Black and White Taxicab Co., supra*, 276 U.S. at 533 (Holmes, J., dissenting).[4]

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[4] Justice Story's belief that it was proper for federal judges to create general common law was closely related to his behalf that the common law ought to embody the natural law. *See* J. MCCLELLAN, JOSEPH STORY AND THE AMERICAN CONSTITUTION 180-83 (1971). Conversely, Justice Holmes's distaste for the "brooding omnipresence" of federal common law was related to his rejection of the idea of natural law. *See id.* at ix-x. Limitations on the lawmaking authority of federal courts need not, however, be based on a rejection of the idea of natural law, since a belief in natural law does not entail the superior capacity or authority of federal judges as translators of natural law into positive law. Similarly, one who rejects the idea of objective right and wrong might logically choose to be a "federal judicial positivist" on the ground that he finds the rules generally made by federal judges more useful than, or otherwise preferable to, rules made by other lawgivers. For the purpose of constitutional analysis, it is enough to observe that judicial decisions *are* a kind of positive law, and that the Constitution reserves lawmaking power to state governments wherever such power has not been delegated to the federal government.

6) Application of any law other than that made by the state having the sovereign power to make the law injures not only one or more litigants, but also the state itself. "Indeed, having the power to make decisions and to set policy is what gives the State its sovereign nature." *F.E.R.C. v. Mississippi*, 456 U.S. 742, 761 (1982). Therefore, "[n]othing can be more disturbing and irritating to the states than an attempted enforcement upon its people of a supposed unwritten law . . . to which they have never assented and which has no existence except in the brain of the Federal judges in their conceptions of what the law of the states should be on the subjects considered. *Baltimore & Ohio R.R. v. Baugh*, 149 U.S. 368, 403 (1893) (Field, J., dissenting). Indeed, "sophisticated students of government understand that these problems involve fundamental questions of power, and that the existence of democracy depends in no small part upon the proper allocation of such authority." Kurland, *Mr. Justice Frankfurter, the Supreme Court and the Erie Doctrine in Diversity Cases*, 67 Yale L.J. 187, 187 (1957).

Although a candid refusal by a federal court to apply state law might be worse than a more casual approach such as that taken by the court below in that the former would add insult to injury, it is also possible that a bold usurpation is *less* dangerous than a quiet one in that it would be more likely to alert Congress to the need for remedial action. Concerning "fundamental questions of power" on which "the existence of democracy depends," some of the most dangerous errors in history have been made by those who proceeded quietly and with good intentions. Unless *mens rea* is to be introduced as a necessary element in establishing the unconstitutionality of federal lawmaking outside the delegated powers of the federal government, a federal court's negligent failure to apply applicable state law cannot be distinguished from a deliberate refusal to apply the same law under otherwise identical circumstances.

III. Without Supreme Court review and reversal of decisions creating general federal common law, other limitations on the federal judicial power will prove illusory.

Casual disregard of state authorities in the course of "interpreting" state law is one of several ways in which federal courts can exceed their constitutional authority to make law. Several recent decisions of this Court have had the effect of closing "loopholes" through which federal judges might have reached desired results at the expense of state sovereignty or the separation of powers. Unless the lower federal courts take seriously their responsibility to apply state law in diversity and pendent jurisdiction cases, however, other limitations on the federal judicial power will have no practical effect.

One way in which the federal courts have made law is by the "interpretation" of broadly-worded federal statutes so as to confer unlimited discretion on federal judges to make rules of law. In *Parrat v. Taylor*, 451 U.S. 527 (1981), this Court reversed a lower federal court's incorporation of the principle that "no loss should go without redress" into 42 U.S.C. § 1983. Significantly, the Court cited *Erie* and observed that there is "no general common law applicable to federal courts" as a basis for deciding cases on the basis of "a single general principle, however just that principle may be in the abstract." *Id.* at 531-32.

Similarly, where the United States has to some extent limited the decisionmaking authority of state governments by attaching conditions to federal grants, lower federal courts have sometimes seemed to regard these conditions as occasions for the wholesale extension into new areas of federal judicial power to define individual and governmental rights and responsibilities. This Court, however, has rejected such a construction. *Pennhurst State School v. Halderman*, 451 U.S. 1 (1981). *See also Guardians Association v. Civil Service Commission of the*

City of New York, 51 U.S.L.W. 5105, 5109 (No. 81-431, decided July 1, 1983): "Since the private cause of action under Title VI [of the Civil Rights of 1964] is one implied by the judiciary rather than expressly created by Congress, we should . . . take care in defining the limits of this cause of action and the remedies available thereunder . . . ."

Even where state sovereignty is perhaps at its lowest ebb—where the Fourteenth Amendment to the Constitution requires the federal courts to review allegations that the state has deprived an individual of life, liberty, or property without due process of law—this Court has rejected attempts by lower federal courts to ignore the specific purposes of the Fourteenth Amendment and to construe it as "a font of tort law to be superimposed upon whatever systems may already be administered by the states." *Paul v. Davis*, 424 U.S. 693, 701 (1976).

Yet another way in which the federal courts might tend to become courts of general common law is by expanding the narrow scope of legitimate federal common lawmaking power. This Court has, however, recognized that it has a special responsibility to review such attempts at expansion. Indeed, "[s]ince the states are represented in Congress but not in the federal courts, the very concerns about displacing state law which counsel again finding pre-emption of *state* law in the absence of clear intent actually suggest a willingness to find congressional displacement of *federal* common law" by subsequent federal legislation. *Milwaukee v. Illinois*, 451 U.S. 304, 317 n.9 (1981).

In each of the types of cases discussed above, this Court reminded lower federal courts that the limitations on their lawmaking power are substantive as well as formal. It is not enough for a federal judge simply to make a ritual bow toward some source of authority—whether it be the Fourteenth Amendment, a federal statute, or the legitimate federal common law—and then to reach whatever result he desires in the case before him.

When the judge treats state law as little more than a base that must be touched prior to going about the business of judicial lawmaking, he achieves the same result as he would have done by using any of these devices the Court has so recently forbidden, and with even less constitutional justification.[5]

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[5] During the first few years after the decision in *Erie*, this Court reviewed a number of lower federal court decisions to determine whether they had correctly applied state law in diversity cases. Most of these were cases in which the lower federal courts had announced that they would follow some state authorities but not others. *See, e.g., West v. American Telephone and Telegraph Co.*, 311 U.S. 223 (1940) (federal courts must follow state intermediate appellate court decisions unless convinced that the state's highest court would decide otherwise); *Vandenmark v. Owens-Illinois Glass Co.*, 311 U.S. 538 (1941) (federal Court of Appeals may not disregard state court decisions rendered after the date of the federal district court judgment being appealed). Two of the lower federal court decisions reviewed and reversed by this Court, however, were strikingly similar to the decision of the Court of Appeals in this case. In *Texarkana v. Arkansas Louisiana Gas Co.*, 306 U.S. 188 (1939), and *Equitable Life Insurance Co. v. Halsey*, 312 U.S. 410 (1941), the courts of appeals had acknowledged their responsibility to apply state law but had in fact decided the principal issues without referring to applicable state court decisions. *See Arkansas Louisiana Gas Co. v. Texarkana*, 97 F.2d 5 (5th Cir. 1938); *Equitable Life Insurance Co. v. Halsey*, 112 F.2d 302 (1940). In the *Texarkana* case the Court of Appeals declared, "We think the appellant has the right of it throughout," because it was "perfectly plain" that a certain contract clause was "completely invalid and unenforceable as an attempt to abdicate and delegate" a legal duty. 97 F.2d at 9. The Supreme Court, however, granted certiorari "on account of asserted conflict with the decisions of the state courts," 306 U.S. at 191, and reversed. 306 U.S. at 201-02. Similarly, the Court of Appeals in the *Equitable Life* case declared, "We see no reason why appellant should be held accountable," since a certain clause in a contract "constituted a valid defense." The Supreme Court of Iowa, however, had concluded otherwise, and so the United States Supreme Court reversed. 312 U.S. at 423-26. The effect of this Court's decisions in *Texarkana* and *Equitable Life* was to remind the lower federal courts that they have an affirmative duty to *apply* state law, not merely to *say* they are applying it. The decision of the Court of Appeals in this case suggests that some federal judges need to be reminded again.

The decision of the court below, like the lower federal court decision that this Court reversed in *Parratt*, was a result of the same phenomenon that gave rise to *Swift v. Tyson*: excessive self-confidence on the part of some federal judges who feel they can provide "juster justice" than that which is embodied in the laws that state legislators and state judges have made. *Cf.* C. WRIGHT, *supra*, § 56 at 262. The "general commercial law" whose discovery was announced in *Swift* has been attributed to a desire on the part of certain federal judges "to establish a major procommercial legal doctrine that had consistently been opposed at the state level" and eventually "to take [commercial] disputes out of what might otherwise be an uncongenial anticommercial environment often found in state courts." M. HORWITZ, THE TRANSFORMATION OF AMERICAN LAW 1780-1860 at 223, 252 (1977). *Erie* came at a time when this Court was reversing yet another wave of federal "judicial activism," in which judges had enforced their own social and economic philosophies under the pretext of finding the common law or interpreting the Constitution. *See, e.g., Lochner v. New York*, 198 U.S. 45 (1905). Recent decisions of this Court, such as *Parratt v. Taylor*, *supra*, are designed to curtail the latest resurgence of federal judicial activism—of which the decision of the court below is an outstanding example. Although the economic and social philosophy being imposed by some judges today, unlike the prevailing judicial philosophy during the *Swift* and *Lochner* eras, can hardly be called "procommercial," the threat to constitutional federalism and to government by the consent of the governed is identical.

This case is a perfect illustration of the point that this Court must police the frontiers of *all* doctrines limiting federal judicial lawmaking power in order for *any* of these limitations to be meaningful. If the court below had construed *federal* securities laws to impose personal

liability on an insurance company officer for treating a corporate asset as though it were worth what the state insurance commissioner said it was worth, the holding would have been quite controversial and would have merited review by this Court. If, on the other hand, a *state* court had been presented with the question of how the state law ought to be construed, it would have reached the opposite result. *See* pages 2-5, *supra*, and authorities cited therein. It would be ironic indeed if the decision below should escape review because it "merely" involves a *federal* court misconstruing *state* law. In which direction a lower federal court bows prior to creating federal common law—whether to the Fourteenth Amendment, to § 1983, to "the general commercial law," or to a "diversity jurisprudence" in which state statutes and state court opinions are overridden by axioms—makes no practical difference. None of these disguises should enable an unconstitutional exercise of federal judicial lawmaking to evade Supreme Court review.

CONCLUSION

For the reasons hereinabove stated, this Court should grant the petition for certiorari.

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August 19, 1983

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No. 82-2091

IN THE
Supreme Court of the United States
OCTOBER TERM, 1982

SHEARN MOODY, JR.,
Petitioner,

v.

DAVID C. MEYERS, *et al.*,
Respondents.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

MOTION FOR LEAVE TO FILE BRIEF OF AMICUS CURIAE, AND BRIEF OF AMICUS CURIAE, CITIZENS ECONOMIC FOUNDATION

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MOTION FOR LEAVE TO FILE BRIEF OF AMICUS CURIAE, CITIZENS ECONOMIC FOUNDATION

The Citizens Economic Foundation, hereby moves this Court pursuant to Supreme Court Rules 36.1 and 42.2(b), for leave to file the annexed Brief of Amicus Curiae in support of the Petition for Writ of Certiorari in this case.

Amicus Citizens Economic Foundation is a non-profit, section 501(c)(3) tax-exempt corporation organized and existing under the laws of Texas.

As stated in its Articles of Incorporation, Citizens Economic Foundation is "dedicated to research and analysis of economic and fiscal policy and their effects on the well-being of individuals and society and the education of the general public thereto." It believes that the issues presented by Petitioner have profound economic and fiscal

implications affecting American society, especially the relationships between business and government. Amicus Curiae is therefore highly interested in the issues presented by the Petitioner.

Accordingly, Amicus respectfully requests that it be permitted to state its views on the merits of the Petition. Amicus will show that the decision of the Fifth Circuit in this case is in error in applying Texas rather than Alabama law and believes further that the Alabama law properly applicable to this action is more favorable to Defendant-Appellant than the Texas law applied by the panel. Authorities and policy arguments not contained in the Petition, but relevant to the issues presented therein, will be discussed.

Respectfully submitted,

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BRIEF OF AMICUS CURIAE, CITIZENS ECONOMIC FOUNDATION

STATEMENT

Amicus Curiae adopts the statement of Petitioner. Pet. 2-6.

INTEREST OF AMICUS

The interest of Amicus Curiae is set forth in the foregoing Motion.

SUMMARY OF ARGUMENT

Amicus believes that because of a change in Texas conflict of laws principles subsequent to the trial, the Fifth Circuit Court committed clear error in applying Texas rather than Alabama law and believes further that the

Alabama law properly applicable to this section is more favorable to Defendant-Appellant than the Texas law applied by the panel. Only last year, the Fifth Circuit Court granted a petition for rehearing to consider the effects of a change in Texas Conflict rules. *Houston North Hospital Properties* v. *Telco Leasing*, 688 F.2d 408 (5th Cir. 1982). Amicus believes that *Houston North Hospital Properties* case controls this case and requires this Court to grant rehearing to consider whether Alabama law applies, and to consider what impact application of Alabama law would have on the case.

ARGUMENT

I. THE FIFTH CIRCUIT COMMITTED CLEAR ERROR IN APPLYING TEXAS RATHER THAN ALABAMA LAW; AND THE ALABAMA LAW APPLICABLE TO THIS ACTION WOULD BE MORE FAVORABLE TO DEFENDANT-APPELLANT THAN THE TEXAS LAW APPLIED BY THE COURT

A. The Court Was Required To Follow Texas Conflict Of Laws Principles In Effect At The Time Of Its Decision In Deciding Which State's Law Would Apply

The Fifth Circuit Court acknowledged that it was required to follow Texas conflict of laws principles, Panel Op. at 1457, citing *Klaxon Co.* v. *Stentor Electric Manufacturing Co.*, 313 U.S. 487 (1941), but it completely failed to do so. Instead, the Court simply assumed that Texas law applied, and then determined that the Texas Business Corporation Act rather than the Texas Insurance Code provided the applicable legal standard. Panel Op. at 1458.[1]

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[1] *Compare Day & Zimmerman, Inc.* v. *Challoner*, 423 U.S. 3 (1975) (per curiam), summarily reversing a decision of the Fifth Circuit Court which declined to apply Texas conflict of laws rules in a diversity case arising out of the Eastern District of Texas. According to the Supreme Court (*id.* at 4-5):

Had the Court focused on Texas conflict of laws principles it would have discovered that while this case was pending on appeal, Texas dramatically changed its conflicts principles, and under those changed principles, Texas courts would have applied Alabama law in the circumstances of this case. Apparently, this change in Texas conflict of laws principle was unknown not only to the Court, but also to the parties.

An appellate court is required to apply the law in effect on the date it renders its decision, not the law in effect at the time of trial. *Bradley* v. *Richmond School Board*, 418 U.S. 696, 711 (1974); *United States* v. *Schooner Peggy*, 5 U.S. (1 Cranch) 103 (1801); *Nations* v. *Sun Oil Co.*, 695 F.2d 933, slip op. at 1986 (5th Cir., January 20, 1983). This principle is fully applicable when the law in effect has been established by judicial decision rather than by legislative enactment. *Gulf Offshore Co.* v. *Mobil Oil Corp.*, 453 U.S. 473, 486 n.16 (1981). The principle has been accepted by Texas courts as a matter of law. *See Houston Lighting & Power Co.* v. *Dickinson Indep. School Dist.*, 641 S.W.2d 302 (Tex. Ct. App. 1982). Thus, even if the trial court was correct, under the old Texas conflict of laws principles, in applying law, the Court was required to determine whether the subsequent change in Texas conflict of laws principles would compel a different result.

At the time of trial, Texas applied the rule of *lex loci delicto* to determine choice of law in tort cases. Under that rule the applicable law is the law of the state where the last act necessary to complete the tort occurred.

"the conflict-of-laws rules to be applied by a federal court in Texas must conform to those prevailing in the Texas state courts. A federal court in a diversity case is not free to engraft exceptions or modifications which may commend themselves to the federal court, but which have not commended themselves to the State in which the federal court sits. The Court of Appeals in this case should identify and follow the Texas conflicts rules."

Amicus believes that even under that old rule, Alabama law should apply. But it is unnecessary to resolve that question because after the trial Texas changed its conflicts rule. In 1979, the Texas Supreme Court abandoned the old *lex loci* approach and adopted instead the "most significant relationship" test set forth in the Restatement (Second) of Conflict of Laws. *Gutierrez* v. *Collins*, 583 S.W.2d 312 (Tex. 1979). *See also Robertson* v. *McKnight*, 609 S.W.2d 534 (Tex. 1981). Neither the Fifth Circuit Court nor the trial court has had an opportunity to consider whether the new Texas conflict of laws rule would compel application of Alabama law. That is not a purely abstract inquiry because, as *amicus* will show in Point C, Alabama law is more favorable to Defendant-Appellant than is Texas law.

Controlling, in this regard, is the Fifth Circuit Court's recent decision in *Houston North Hospital Properties* v. *Telco Leasing*, 688 F.2d 408 (5th Cir. 1982). This was a diversity case, arising out of a federal district court in Texas, in which a threshold issue was whether Illinois or Texas law applied. The panel, in its initial decision, looked to Texas conflict of laws rules and concluded that Texas would apply the *lex loci* rule to determine the applicable law. 680 F.2d 19, 21 (5th Cir. 1982). The Court granted a petition for rehearing, however, when made aware that the Texas Supreme Court, in *Gutierrez*, *supra*, had abandoned the *lex loci* rule and had adopted the "most significant relationship" test. On rehearing, the panel considered which state's law would apply under the new Texas conflict of laws rule. *Amicus* submits that *Houston North Hospital Properties* is controlling on the facts of the present case, and repairs that this Court grant the petition for Certiorari.

B. Under Current Texas Conflict Of Laws Principles, Texas Courts Would Apply Alabama Law In The Circumstances Of This Case

As noted, subsequent to the trial of this action, Texas adopted the "most significant relationship" test codified in the Restatement (Second) of Conflict of Laws. Under that test Texas courts would apply Alabama law. The Restatement creates a presumption that the law of the *state of incorporation* governs the rights and duties of corporate officers and directors. Section 309 states that

> "The local law of the state of incorporation will be applied to determine the existence and extent of a director's or officer's liability to the corporation, its creditors and shareholders, except where, with respect to a particular issue, some other state law has a more significant relationship under the principles stated in § 6 to the parties and the transaction, in which event the local law of the other state will be applied."

Comment a to § 309 states that "[l]iability will typically be imposed upon directors under the rule of this Section for such matters as the fraudulent or negligent mismanagement of the Corporation's affairs."[2] Because Empire was at all times relevant to this lawsuit an Alabama corporation, the new Texas conflict rules presumptively apply the law of Alabama to determine liability of directors for corporate mismanagement.[3]

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[2] *See Shaffer* v. *Heitner*, 433 U.S. 186, 214 n.44 (1977) ("[i]n general, the law of the state of incorporation is held to govern the liabilities of officers and directors of the corporation to its stockholders. See Restatement § 309. . . . The rationale for the general rule appears to be based . . . on the need for a uniform and certain standard to govern the internal affairs of a corporation. . . .").

[3] Other courts applying the Restatement approach to cases involving insurance companies in liquidation agree that the applicable law is that of the state where the insurance company is incorporated. *See, e.g., Manchester Premium Budget Corp.* v. *Manchester Insurance & Indemnity Co.*, 612 F.2d 389, 391-92 n.8 (8th Cir. 1980); *Jump* v. *Goldenhersh*, 474 F. Supp. 1306 (E.D. Mo. 1979), *aff'd*, 619 F.2d 11 (8th Cir. 1980). The district court in *Jump* v.

Moreover, even aside from the presumptive applicability of Alabama law resulting from the fact that Empire was incorporated in Alabama, it is clear that Alabama has the most significant relationship with the issues in this action, as defined in Restatement §§ 6 and 145.[4] Although Empire's principal headquarters were in

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Goldenhersh, supra, noted that it was particularly important to apply the law of the state of incorporation in such cases:

> "Insurance liquidation cases do not follow the same conflicts of law doctrine which applies to contract or tort cases. According to Missouri conflicts of law doctrine for insurance cases, the substantive law of the state of incorporation and domicile should be applied, even if most of the events in this case happened in Missouri. Most states have found it wise to follow this doctrine because insurance companies have traditionally been self-regulated, rather than being subjected to the Federal Bankruptcy Act . . . and the state laws form a delicately balanced network designed to protect all creditors of an insurance equally, regardless of the state of their residence."

474 F. Supp. at 1313.

[4] Section 6 provides:

> "(1) A court, subject to constitutional restrictions, will follow a statutory directive of its own state on choice of law.
>
> (2) When there is no such directive, the factors relevant to the choice of the applicable rule of law include
>
> (a) the needs of the interstate and the international system,
>
> (b) the relevant policies of the forum;
>
> (c) the relevant policies of other interested states and the relative interest of those states in the determination of the particular issue;
>
> (d) the protection of justified expectations;
>
> (e) the basic policies underlying the particular field of law;
>
> (f) certainty, predictability, and uniformity of result; and
>
> (g) ease in the determination and application of the law to be applied."

Section 145 provides:

> "(1) The rights and liabilities of the parties with respect to an issue of tort are determined by the local law of the state

Texas, it was an Alabama insurance company. The increased value of the life interest was submitted to the Alabama Superintendent of Insurance for approval, and Empire's acquisition and expansion program involved the merger of various other companies into an Alabama corporation. Alabama clearly has a greater interest than Texas in regulating the affairs of an Alabama insurance company, especially in a suit brought by a receiver appointed by an Alabama court pursuant to an Alabama statute. Application of Alabama law, the state of incorporation, would yield more predictable and uniform results than would application of the law of a state, such as Texas, where a company merely does business. And application of Alabama law appears best suited to protect justified expectations.

C. The Alabama Law Properly Applicable To This Action Is More Favorable To Defendant-Appellant Than The Texas Law Applied By The Court

The Fifth Circuit Court applied the Texas law of mismanagement and fiduciary responsibility. The Court described the requirements of Texas law as follows:

> "Texas law imposes on corporate officers and directors a duty to exercise due care in the manage-

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which, with respect to that issue, has the most significant relationship to the occurrence and parties under the principles stated in section 6.

(2) Contacts to be taken into account in applying the principles of section 6 to determine the law applicable to an issue include:

(a) the place where the injury occurred;

(b) the place where the conduct causing the injury occurred;

(c) the domicile, residence, nationality, place of incorporation and place of business of the parties; and

(d) the place where the relationship, if any, between the parties is centered.

These contacts are to be evaluated according to their relative importance with respect to the particular issue."

> ment of the corporation's affairs. If they breach that duty, they are liable to the corporation for any loss it may suffer as a result of their neglect. . . . 'Due care' is that degree of care which a person of ordinary prudence would exercise under the same or similar circumstances."

Panel Op. at 1458. The Court determined, therefore, that Texas imposes liability on corporate officers and directors for their *negligent* actions.[5]

Alabama law, however, does *not* impose liability for negligence. Instead, officers and directors are liable only for losses to the corporation resulting from their willful and intentional departures from duty, fraudulent breaches of trust, gross negligence, or ultra vires acts, and are not liable if they act in good faith and without gross negligence supporting an imputation of fraud. *Deal* v. *Johnson*, 362 So.2d 214 (Ala. 1978); *Van Antwerp Realty Corp.* v. *Cooke*, 162 So. 97, 230 Ala. 535 (1935); *Sellers* v. *Head*, 73 So.2d 747, 261 Ala. 212 (1954); *King* v. *Livingston Mfg. Co.*, 68 So. 897, 192 Ala. 269 (1915). Accordingly, the standard of director liability under Alabama law is considerably more favorable to Defendant-Appellant than is the analogous rule under Texas law.

Moreover, because the Court did not apply the substantive law of Alabama, it did not consider whether the Alabama statute of limitations applies to this case.[6] The

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[5] This interpretation is fully supported by the relevant precedents. *See Sutton* v. *Reagan & Gee*, 405 S.W.2d 828 (Tex. Civ. App., writ ref'd n.r.e.); *Fagan* v. *La Gloria Oil & Gas Co.*, 494 S.W.2d 624 (Tex. Civ. App., no writ); *Emmert* v. *Drake*, 224 F.2d 299 (5th Cir. 1955).

[6] Although statutes of limitations are sometimes considered "procedural", they may also be treated as substantive limitations on the underlying right of action. *Cf. Click* v. *Thuron Indus., Inc.*, 460 S.W.2d 506 (Tex. Civ. App. 1970); *Francis* v. *Herrin Transportation Co.*, 423 S.W.2d 610 (Tex. Civ. App. 1968); Restatement (Second) of Conflict of Laws §§ 142(2), 143. Because this Court applied Texas substantive law, it did not consider whether the appli-

Fifth Circuit Court applied the Texas statute of limitations, which provides for a *two* year period of limitations after the "fraud" is "discovered" or with reasonable diligence should have been discovered.[7] The relevant Alabama statute of limitations provides for a *one* year period of limitations,[8] and since Alabama has expressly rejected the "discovery" rule, the one year period begins to run when the events which form the basis of the tort occurred, whether or not those events were known or discovered at that time.[9]

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cable Alabama statute of limitations was substantive or procedural for purposes of the Texas conflict of laws rules.

[7] Actually, the *state* law claims (either under Texas law or Alabama law) were *not* based on fraud, but on mismanagement or breach of fiduciary duty, and it therefore seems inappropriate to apply the Texas "discovery" rule, or any other special rule that applies only in "fraud" cases.

[8] Alabama Code § 6-2-39(5). This one year period applies to actions for negligence of corporation directors in performing their duties. *Blythe* v. *Enslen*, 203 Ala. 692, 85 So. 1 (1919).

[9] In *Garrett* v. *Raytheon Co.*, 368 So.2d 516 (Ala. 1979), the Alabama Supreme Court held that a claim for exposure to radiation was time-barred even though the plaintiff did not discover the injury until the limitations period had expired. The court recognized the trend in other states towards accepting the discovery rule, but stated that the rule "has been specifically rejected by Alabama courts for the past 60 years." *Id.* at 521. The court said that

> "It may be that Alabama's rejection of the 'Discovery Rule' is contrary to the weight of opinion generally. However, as this Court is committed to the proposition that the legislature has the *inherent power* to establish statutes of limitation, we have no other alternative than to leave it to the legislature to abrogate this rule and adopt a more equitable one should it see fit, so that a plaintiff's claim will not be barred when he has no way to ascertain that he has been damaged . . . because the result has not manifested itself until the statute of limitations has run."

Id. (emphasis in original). *See also City of Gadsen* v. *Harbin*, 398 So.2d 707 (Ala. Civ. App. 1981); *Lovell* v. *Smith*, 232 Ala. 626, 169 So. 280 (1936).

As the Fifth Circuit Court noted, "the events which form the basis of Receiver's state and federal claims occurred more than three years before this suit was commenced." Panel Op. at 1455. Thus, because Alabama rejects the discovery rule, and has a one year period of limitations, this action would be barred under Alabama law.

CONCLUSION

In summary, it is understandable that the Fifth Circuit Court did not apply the new Texas conflict of laws principles, because the change in Texas law occurred after the trial and was apparently unknown to the Court or to the parties. Nevertheless, as the Court ruled in *Houston North Hospital Properties*, in those circumstances an appellate court should grant a petition for rehearing and, on rehearing, apply the Texas conflict of laws rule in effect at the time of its decision. Because of the change in Texas law, neither the trial court nor the Fifth Circuit Court has had an opportunity to consider whether Texas law would now require application of Alabama law, and if so, whether the judgment can be sustained under Alabama law. These questions are important not only to Defendant-Appellant, but also to Alabama, to Texas, and to all lawyers and litigants faced with conflict of laws issues.

Accordingly, this Court should grant the petition of Certiorari.

Respectfully submitted,

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No. 82-2091

IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

SHEARN MOODY, JR.,
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v.

DAVID C. MEYERS, *et al.*,
Respondents.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

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BRIEF AMICI CURIAE OF THE STATE OF MISSOURI AND THE STATE OF OKLAHOMA

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IN THE

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BRIEF AMICI CURIAE OF THE STATE OF MISSOURI AND THE STATE OF OKLAHOMA

INTERESTS OF THE AMICI CURIAE STATE OF MISSOURI AND THE STATE OF OKLAHOMA

The States of Missouri and Oklahoma have a strong interest in the integrity of the federal system ordained by the United States Constitution, and particularly in preventing federal courts from substituting themselves for state lawmaking authorities in the exercise of lawmaking power outside the scope of the powers which have been delegated to the federal government by the Constitution, and which Congress has chosen to exercise. The States of Missouri and Oklahoma hope to persuade this Court to review and reverse the holding of the court below in order to reaffirm the constitutional limits on the powers of the federal judiciary and the constitutional integrity of the states as lawmaking bodies.

STATEMENT OF THE CASE

Amici hereby adopt by reference the Statement of the Case contained in the Petition for Writ of Certiorari at 2-6.

SUMMARY OF ARGUMENT

The concept of federalism embodied in the United States Constitution requires that the states retain not only titular authority to make decisions on matters not delegated to the central government, but also real power to enforce such decisions. Accordingly, when a federal court substitutes its own notions of sound policy for the applicable positive law that has been enacted by a state legislature or pronounced by a state court, the federal court does more than violate a "technical doctrine of procedure or jurisdiction." Rather, the unwarranted creation of "general federal common law" strikes at "the heart of the relations between the federal government and the states . . . ." C. WRIGHT, HANDBOOK ON THE LAW OF FEDERAL COURTS § 55 at 255 (3d ed. 1976); *see Erie Railroad Co. v. Tompkins*, 304 U.S. 64 (1938).

In this case the Court of Appeals did not simply err in an attempt to apply state law. Rather, it made no attempt to determine what state law provided on the pivotal question in the case. The court brushed aside specific contentions about the statute and decisional law of Texas and Alabama with a single reference to an asserted general principle of law. This principle, however, had been repeatedly rejected by the state courts and state legislatures whose decisions the federal court was bound to apply.

The *only* remedy for the creation of general common law by a federal court in an area outside the authority of the federal government is review and reversal by this Court. In several recent decisions, this Court has reminded lower federal courts that not even the most broadly worded of federal statutes and constitutional provisions are to be construed so as to transform federal courts into courts of general common law. These admonitions will prove to be pointless if federal judges are free to reach whatever results they desire, without fear of Supreme Court review, simply by resorting to the rubric of "interpretation" of state rather than federal law. This

Court should therefore grant certiorari in this case in order to make it clear that *Erie* requires a sincere and thorough effort to discern and apply state law in pendent and diversity cases, even where the positive law of the state contravenes general principles in which the federal judge strongly believes.

I. The holding of the court below was clearly contrary to the applicable state law.

The Court of Appeals held that "there was *only one wrong complained of and proved:* the manipulation of the life interest leading to fatal undercapitalized acquisition." Pet. App. 27 (emphasis supplied). This "manipulation" was held to consist in the petitioner's requesting the Alabama Insurance Commissioner to revalue a life interest owned by the corporation, and his subsequent actions as an officer and director of the corporation in undertaking acquisitions "based on an artificial surplus created by the $14,403,200 revaluation of the life interest." Pet. App. 21. Petitioner contended in the proceeding below, however, that under the applicable law[1] the In-

[1] The Court of Appeals seems to have assumed that Texas substantive law applied to most issues in the case. Acknowledging that it was required to follow Texas conflict of laws principles, Opinion at 1458, the court did not in fact inquire into the conflict of law rule that Texas would have applied, but simply applied Texas law (except on the decisive issue in the case, where it neither cited any state law nor alluded to the absence of state authorities—see text at pages 2-5, *infra*). In fact, the opinion in *Gutierrez v. Collins*, 583 S.W.2d 312 (Tex. 1979), suggests that a Texas state court would have applied Alabama substantive law. *Gutierrez* was decided while the appeal in this case was pending, but it should have been followed by the Court of Appeals. *See Vandenmark v. Owens-Illinois Glass Co.*, 311 U.S. 538 (1941). The Court's failure to apply Alabama law would only be relevant if the substantive law of Texas was different from that of Alabama. In fact, had the Court of Appeals consulted *either* Texas or Alabama law on the question whether a state administrative decision can be collaterally attacked in a private suit for damages, it would have been forced to decide for petitioner rather than for respondents. *See* text as pages 2-5, *infra*.

surance Commissioner's ruling on the value of the life interest was not subject to collateral attack in an action for damages. If petitioner had prevailed on this point—*i.e.*, if the courts below had regarded themselves as *bound* by the administrative ruling that the life interest *was* worth $14 million—then petitioner could not have been held "grossly negligent" for acting in accordance with the Commissioners' finding and not with some other and perhaps better evaluation of what the life interest was worth.[2]

In rejecting petitioner's argument against collateral attack on the Commissioner's ruling, the Court of Appeals cited no authority and only the following analysis:

> This contention is spurious. An insurance company may not delegate responsibility for valuation of its assets to a state agency, and the mere fact that an insurance commissioner accepts a company's asset valuation does not immunize the company from liability arising from that valuation.

Pet. App. 22 n.11. This rule, on which the whole case turned, is directly contrary to the rule that would have been applied if the case had been tried in a state court.

The acts of the Alabama Insurance Commissioner are expressly made "quasi-judicial" by statute. Ala. Code § 27-2-31(a) (1975). The Commissioner's statutory duty

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[2] The court below also stated that the Commissioner "might" have been "swayed by considerations of friendship and obligation in approving the increased valuation of the life interest," Pet. App. 8 n.4, and that during an earlier proceeding than the one on which petitioner's liability was based, petitioner has "failed to disclose his belief that the trust interest was intended to be non-transferable." Pet. App. 26. Neither of these statements, however, was any part of the court's holding, since neither was found to have contributed to "the one wrong complained of and proved." Pet. App. 27. If the court below had regarded itself as bound by the Commissioner's finding that the life interest *was* worth $14 million, neither of these allegations could have created liability on the part of the petitioner, since all damage and all liability in the case were found to have resulted from the life interest being worth *less* than the Commissioner had found it to be worth.

includes a duty to make an independent appraisal of the value of the corporation's reserve assets. *Id.* § 27-2-21. This appraisal was made in writing after a hearing at which documentary and testimonial evidence was adduced. Pet. App. 7-8; DX 6. The statute provides an exclusive method for direct attack on rulings of the Commissioner, which must be brought in the circuit court of Montgomery County, Alabama. Ala. Code § 27-2-32 (1975). Similarly, in Texas (the forum state in the proceedings below, whose law the Court of Appeals applied on other questions and presumably would have applied to this question had it designed to apply state law at all), a direct attack on any "rule, regulation, order, decision or finding" of the State Board of Insurance is subject to review by suit filed in the state district court in Travis County, Texas, "and not elsewhere." Tex. Ins. Code Ann. art. 1.15, § 4 (Vernon 1981). Collateral attacks on agency determinations in private suits for damages are forbidden. *Railroad Commission v. McKnight*, 619 S.W.2d 255 (Tex. Civ. App. 1981); *Bolton v. Coats*, 514 S.W.2d 482 (Tex. Civ. App. 1974); *Railroad Commission v. Marathon Oil Co.*, 89 S.W.2d 517 (Tex. Civ. App. 1935); *Kirby Lumber Co. v. Adams*, 62 S.W.2d 366 (1933). *Accord, State v. Brooks*, 53 So. 2d 329 (Ala. 1951); *Huntsville v. Goodenrath*, 68 So. 676 (Ala. 1915). This rule flows from the quasi-judicial nature of administrative agency determinations and from the need for certainty in business transactions; it does not depend on the soundness of the business judgment, or even on the "good faith," of parties who have treated the administrative finding as though it were true rather than false. Thus, for example, an allegation that a defendant in an action for damages procured an administrative finding by making false statements to the tribunal was insufficient to allow the plaintiff to controvert the finding. *Bolton v. Coats, supra*, 514 S.W.2d at 487. These holdings are incompatible with the rule fashioned by the Court of Appeals in this case to the effect that a state may not "delegate" responsibility for evaluating its assets to a state agency, since

the sole effect of this "non-delegation doctrine" was to allow the evaluation to be controverted in a collateral action for damages.

II. The unconstitutionality of the court's decision to fashion a rule contrary to state law was not mitigated by the court's failure to announce its rejection of the state law.

Since *Erie Railroal Company v. Tompkins*, 304 U.S. 64 (1938), this Court has recognized that when a federal court substitutes rules of its own choosing for the statute or decisional law of a State whose sovereignty includes the power to make the law, the court violates the Constitution.

The decision of the court below to create "federal common law" rather than to follow the applicable state law was obfuscated by the court's failure to identify the source of the rule on which it resolved the case. While the court did not attempt to show that its "non-delegation" rule was derived from, or even consistent with, the law of Texas or Alabama, it also refrained from *announcing* that it was applying or creating federal common law. This does not change the nature of the decision. If the Court of Appeals had dealt thoroughly and candidly with the Texas and Alabama statutes and decisions, and then rejected them as "spurious" because they conflicted with a general overarching rule of law to the effect that companies may not "delegate" fact-finding responsibility to state agencies, there would have been no doubt of the court's violation of the Constitution as construed by the Court in *Erie*. Surely there can be no constitutional difference between a candid disavowal of applicable state authorities and a rejection *sub silentio* of the same authorities for the same purpose and to the same effect.

In a sense, federal courts create general federal common law whenever they make incorrect guesses about how state supreme courts would decide the questions of state law with which they are presented. *See, e.g., Vanden-*

mark v. Owens-Illinois Glass Co., 311 U.S. 538 (1941). It would be neither possible nor desirable, however, for this Court to grant certiorari in order to consider every allegation that a federal court had simply *misconstrued* state law. What distinguishes this case—what makes it *at least* as destructive of the constitutional principle of federalism as a candid usurpation of state lawmaking power would have been—is that the court below made no *attempt* to apply state law to the question on which the case turned. If there had been no state statutes or decisions to be found, moreover, the court's failure to allude to its duty to apply state law would be no more than evidence of an unhealthy tendency to forget the role of the federal courts within the federal system; but in this case the court ignored state statutes and decisions that clearly contradicted its holding. Finally, in this case the way in which the court contrived to ignore state law—by rejecting a litigant's references to the enacted and decisional law of a state as "spurious" on the ground that they conflict with a general statement apparently derived from the court's apprehension of "the" law—is the very mode of judicial decisionmaking that *Erie* forbade.

When these three factors are present in a diversity or pendent jurisdiction[3] case—failure to cite state law or to allude to the absence of state authorities, a decision that clearly contravenes state law, and an apparent resolution of the state law question by reference to an asserted general principle of law—the decision partakes of all the evils that are characteristic of "federal general common law," whether or not the decision describes itself as a federal common law decision. Decisions such as the one rendered by the court below meet all the criteria by

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[3] The court below did not find it necessary to determine whether its authority to decide state law questions was based on diversity jurisdiction or on pendent jurisdiction. In either case a federal court's obligation is to follow the decisions of the state courts.

which impermissible federal common lawmaking is commonly characterized:

1) When different rules are applied in state and federal courts respectively—regardless of whether the federal courts admit they are applying different rules, and assuming only the "[p]ersistence of state courts in their own opinions on questions of common law," *Erie*, *supra*, 304 U.S. at 74—there will be a lack of uniformity in the law and a corresponding uncertainty surrounding commercial transactions.

2) Similarly, although diversity jurisdiction "was conferred in order to prevent apprehended discrimination in state courts against those not citizens of the State," application of different substantive rules in federal courts introduces "grave discrimination by non-citizens against citizens" by making "rights enjoyed under the unwritten 'general law' vary according to whether enforcement [is] sought in the state or federal court," and giving the power of selecting the forum (and hence the law) to the non-citizen. *Id.* at 74-75.

3) Whether an error results from a wilful rejection of the court's duty to apply state law or from a *sub silentio* rejection of state law in favor of an asserted general principle has no bearing on whether the error is "outcome-determinative." *See Guaranty Trust Company of New York v. York*, 326 U.S. 99 (1945). In this case the result reached by the courts below could not have been reached if the courts had followed the Texas and Alabama rule against collateral attacks on administrative rulings in private suits for damages, rather than the contradictory general principle formulated by the Courts of Appeals. See pages 2-5, *supra*.

4) Nor is this issue within one of the "narrow areas" in which the federal courts are "free to develop a common law" absent a delegation from Congress pursuant to a constitutional grant of federal power. These areas include

"those concerned with the rights and obligations of the United States, interstate and international disputes implicating the conflicting rights of States or our relations with foreign nations, and admiralty cases." *Texas Industries, Inc. v. Radcliff Materials, Inc.*, 451 U.S. 630, 641 (1981) (footnotes omitted). *See generally Clearfield Trust Co. v. United States*, 318 U.S. 363 (1943); *Illinois v. Milwaukee*, 406 U.S. 91 (1972); *Fitzgerald v. United States Lines*, 374 U.S. 16 (1963). One danger flowing from an attitude among federal judges that they ought to formulate general principles of law to govern disputes between private parties outside these specialized areas is that the federal courts will then pay insufficient attention to the development of guidelines to determine when it *is* appropriate to apply or create federal common law. *See* Friendly, *In Praise of Erie—And of the New Federal Common Law*, 39 N.Y.U. L. Rev. 383 (1964). This danger is aggravated rather than alleviated when a federal court creates federal common law without acknowledging (and perhaps even without quite knowing) that it is doing so.

5) The outstanding characteristic of the general federal common law prior to *Erie* was the theoretical premise from which it proceeded: that there is "a transcendental body of law outside of any particular state but obligatory within it unless and until changed by statute." *Black and White Taxicab Company v. Brown and Yellow Taxicab Company*, 276 U.S. 518, 533 (1928) (Holmes, J., dissenting). In *Swift v. Tyson*, 16 Pet. (41 U.S.) 1 (1842), for instance, the Court found it "necessary . . . to express our own opinion of the true result of the commercial law upon the question now before us," notwithstanding the New York decisions that had already addressed the question. *Id.* at 19. The more firmly the judges became convinced that the commercial law was an objectively ascertainable set of principles (like "a brooding ominpresence in the sky," *Southern Pacific Railroad Co. v. Jensen*, 244 U.S. 205, 222 (1917) (Holmes, J.)), however, the more

likely it became that the "general law" would amount to "little less than what the judge advancing the doctrine thinks at the time should be the general law." *Baltimore & Ohio R.R. v. Baugh*, 149 U.S. 368, 401 (1893) (Field, J., dissenting). This theoretical premise and this style of decisionmaking were also the premise and the style of the court below. The Court of Appeals did not find it necessary to inquire into state law on the question because it felt *sure* that petitioner's argument was "spurious." Pet. App. 22 n.11. The argument was "spurious" because it conflicted with a general principle in which the court obviously believed quite strongly. *See id.* This approach to decisionmaking is precisely the approach taken in *Swift* and declared unconstitutional in *Erie*. The error of the court below was to base the petitioner's liability on a principle imported from a source other than (and, as it happens, hostile to) the statute and decisional law of Texas and Alabama. "But there is no such body of law. The fallacy and illusion . . . consist in supposing that there is this outside thing to be found." *Black and White Taxicab Co., supra*, 276 U.S. at 533 (Holmes, J., dissenting).[4]

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[4] Justice Story's belief that it was proper for federal judges to create general common law was closely related to his belief that the common law ought to embody the natural law. *See* J. McCLELLAN, JOSEPH STORY AND THE AMERICAN CONSTITUTION 180-83 (1971). Conversely, Justice Holmes's distaste for the "brooding omnipresence" of federal common law was related to his rejection of the idea of natural law. *See id.* at ix-x. Limitations on the lawmaking authority of federal courts need not, however, be based on a rejection of the idea of natural law, since a belief in natural law does not entail the superior capacity or authority of federal judges as translators of natural law into positive law. Similarly, one who rejects the idea of objective right and wrong might logically choose to be a "federal judicial positivist" on the ground that he finds the rules generally made by federal judges more useful than, or otherwise preferable to, rules made by other lawgivers. For the purpose of constitutional analysis, it is enough to observe that judicial decisions *are* a kind of positive law, and that the Constitution reserves lawmaking power to state governments wherever such power has not been delegated to the federal government.

6) Application of any law other than that made by the state having the sovereign power to make the law injures not only one or more litigants, but also the state itself. "Indeed, having the power to make decisions and to set policy is what gives the State its sovereign nature." *F.E.R.C. v. Mississippi*, 456 U.S. 742, 761 (1982). Therefore, "[n]othing can be more disturbing and irritating to the states than an attempted enforcement upon its people of a supposed unwritten law . . . to which they have never assented and which has no existence except in the brain of the Federal judges in their conceptions of what the law of the states should be on the subject considered. *Baltimore & Ohio R.R. v. Baugh*, 149 U.S. 368, 403 (1893) (Field, J., dissenting). Indeed, "sophisticated students of government understand that these problems involve fundamental questions of power, and that the existence of democracy depends in no small part upon the proper allocation of such authority." Kurland, *Mr. Justice Frankfurter, the Supreme Court and the Erie Doctrine in Diversity Cases*, 67 Yale L.J. 187, 187 (1957).

Although a candid refusal by a federal court to apply state law might be worse than a more casual approach such as that taken by the court below in that the former would add insult to injury, it is also possible that a bold usurpation is *less* dangerous than a quiet one in that it would be more likely to alert Congress to the need for remedial action. Concerning "fundamental questions of power" on which "the existence of democracy depends," some of the most dangerous errors in history have been made by those who proceeded quietly and with good intentions. Unless *mens rea* is to be introduced as a necessary element in establishing the unconstitutionality of federal lawmaking outside the delegated powers of the federal government, a federal court's negligent failure to apply applicable state law cannot be distinguished from a deliberate refusal to apply the same law under otherwise identical circumstances.

III. Without Supreme Court review and reversal of decisions creating general federal common law, other limitations on the federal judicial power will prove illusory.

Casual disregard of state authorities in the course of "interpreting" state law is one of several ways in which federal courts can exceed their constitutional authority to make law. Several recent decisions of this Court have had the effect of closing "loopholes" through which federal judges might have reached desired results at the expense of state sovereignty or the separation of powers. Unless the lower federal courts take seriously their responsibility to apply state law in diversity and pendent jurisdiction cases, however, other limitations on the federal judicial power will have no practical effect.

One way in which the federal courts have made law is by the "interpretation" of broadly-worded federal statutes so as to confer unlimited discretion on federal judges to make rules of law. In *Parrat v. Taylor*, 451 U.S. 527 (1981), this Court reversed a lower federal court's incorporation of the principles that "no loss should go without redress" into 42 U.S.C. § 1983. Significantly, the Court cited *Erie* and observed that there is "no general common law applicable to federal courts" as a basis for deciding cases on the basis of "a single general principle, however just that principle may be in the abstract." *Id.* at 531-32.

Similarly, where the United States has to some extent limited the decisionmaking authority of state governments by attaching conditions to federal grants, lower federal courts have sometimes seemed to regard these conditions as occasions for the wholesale extension into new areas of federal judicial power to define individual and governmental rights and responsibilities. This Court, however, has rejected such a construction. *Pennhurst State School v. Halderman*, 451 U.S. 1 (1981). *See also Guardians Association v. Civil Service Commission of the*

City of New York, 51 U.S.L.W. 5105, 5109 (No. 81-431, decided July 1, 1983): "Since the private cause of action under Title VI [of the Civil Rights of 1964] is one implied by the judiciary rather than expressly created by Congress, we should . . . take care in defining the limits of this cause of action and the remedies available thereunder . . . ."

Even where state sovereignty is perhaps at its lowest ebb—where the Fourteenth Amendment to the Constitution requires the federal courts to review allegations that the state has deprived an individual of life, liberty, or property without due process of law—this Court has rejected attempts by lower federal courts to ignore the specific purposes of the Fourteenth Amendment and to construe it as "a font of tort law to be superimposed upon whatever systems may already be administered by the states." *Paul v. Davis*, 424 U.S. 693, 701 (1976).

Yet another way in which the federal courts might tend to become courts of general common law is by expanding the narrow scope of legitimate federal common lawmaking power. This Court has, however, recognized that it has a special responsibility to review such attempts at expansion. Indeed, "[s]ince the states are represented in Congress but not in the federal courts, the very concerns about displacing state law which counsel against finding pre-emption of *state* law in the absence of clear intent actually suggest a willingness to find congressional displacement of *federal* common law" by subsequent federal legislation. *Milwaukee v. Illinois*, 451 U.S. 304, 317 n.9 (1981).

In each of the types of cases discussed above, this Court reminded lower federal courts that the limitations on their lawmaking power are substantive as well as formal. It is not enough for a federal judge simply to make a ritual bow toward some source of authority—whether it be the Fourteenth Amendment, a federal statute, or the legitimate federal common law—and then to reach whatever result he desires in the case before him. When the

judge treats state law as little more than a base that must be touched prior to going about the business of judicial lawmaking, he achieves the same result as he would have done by using any of these devices the Court has so recently forbidden, and with even less constitutional justification.[5]

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[5] During the first few years after the decision in *Erie*, this Court reviewed a number of lower federal court decisions to determine whether they had correctly applied state law in diversity cases. Most of these were cases in which the lower federal courts had announced that they would follow some state authorities but not others. *See, e.g., West v. American Telephone and Telegraph Co.*, 311 U.S. 223 (1940) (federal courts must follow state intermediate appellate court decisions unless convinced that the state's highest court would decide otherwise); *Vandenmark v. Owens-Illinois Glass Co.*, 311 U.S. 538 (1941) (federal Court of Appeals may not disregard state court decisions rendered after the date of the federal district court judgment being appealed). Two of the lower federal court decisions reviewed and reversed by this Court, however, were strikingly similar to the decision of the Court of Appeals in this case. In *Texarkana v. Arkansas Louisiana Gas Co.*, 306 U.S. 188 (1939), and *Equitable Life Insurance Co. v. Halsey*, 312 U.S. 410 (1941), the courts of appeals had acknowledged their responsibility to apply state law but had in fact decided the principal issues without referring to applicable state court decisions. *See Arkansas Louisiana Gas Co. v. Texarkana*, 97 F.2d 5 (5th Cir. 1938); *Equitable Life Insurance Co. v. Halsey*, 112 F.2d 302 (1940). In the *Texarkana* case the Court of Appeals declared, "We think the appellant has the right of it throughout," because it was "perfectly plain" that a certain contract clause was "completely invalid and unenforceable as an attempt to abdicate and delegate" a legal duty. 97 F.2d at 9. The Supreme Court, however, granted certiorari "on account of asserted conflict with the decisions of the state courts," 306 U.S. at 191, and reversed. 306 U.S. at 201-02. Similarly, the Court of Appeals in the *Equitable Life* case declared, "We see no reason why appellant should be held accountable," since a certain clause in a contract "constituted a valid defense." The Supreme Court of Iowa, however, had concluded otherwise, and so the United States Supreme Court reversed. 312 U.S. at 423-26. The effect of this Court's decisions in *Texarkana* and *Equitable Life* was to remind the lower federal courts that they have an affirmative duty to *apply* state law, not merely to *say* they are applying it. The decision of the Court of Appeals in this case suggests that some federal judges need to be reminded again.

The decision of the court below, like the lower federal court decision that this Court reversed in *Parratt*, was a result of the same phenomenon that gave rise to *Swift v. Tyson:* excessive self-confidence on the part of some federal judges who feel they can provide "juster justice" than that which is embodied in the laws that state legislators and state judges have made. *Cf.* C. WRIGHT, *supra*, § 56 at 262. The "general commercial law" whose discovery was announced in *Swift* has been attributed to a desire on the part of certain federal judges "to establish a major procommercial legal doctrine that had consistently been opposed at the state level" and eventually "to take [commercial] disputes out of what might otherwise be an uncongenial anticommercial environment often found in state courts." M. HORWITZ, THE TRANSFORMATION OF AMERICAN LAW 1780-1860 at 223, 252 (1977). *Erie* came at a time when this Court was reversing yet another wave of federal "judicial activism," in which judges had enforced their own social and economic philosophies under the pretext of finding the common law or interpreting the Constitution. *See, e.g., Lochner v. New York*, 198 U.S. 45 (1905). Recent decisions of this Court, such as *Parratt v. Taylor*, *supra*, are designed to curtail the latest resurgence of federal judicial activism—of which the decision of the court below is an outstanding example. Although the economic and social philosophy being imposed by some judges today, unlike the prevailing judicial philosophy during the *Swift* and *Lochner* eras, can hardly be called "procommercial," the threat to constitutional federalism and to government by the consent of the governed is identical.

This case is a perfect illustration of the point that this Court must police the frontiers of *all* doctrines limiting federal judicial lawmaking power in order for *any* of these limitations to be meaningful. If the court below had construed *federal* securities laws to impose personal liability on an insurance company officer for treating a cor-

porate asset as though it were worth what the state insurance commissioner said it was worth, the holding would have been quite controversial and would have merited review by this Court. If, on the other hand, a *state* court had been presented with the question of how the state law ought to be construed, it would have reached the opposite result. *See* pages 2-5, *supra*, and authorities cited therein. It would be ironic indeed if the decision below should escape review because it "merely" involves a *federal* court misconstruing *state* law. In which direction a lower federal court bows prior to creating federal common law—whether to the Fourteenth Amendment, to § 1983, to "the general commercial law," or to a "diversity jurisprudence" in which state statutes and state court opinions are overridden by axioms—makes no practical difference. None of these disguises should enable an unconstitutional exercise of federal judicial lawmaking to evade Supreme Court review.

CONCLUSION

For the reasons hereinabove stated, this Court should grant the petition for certiorari.

Respectfully submitted,

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August 19, 1983

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No. 82-2091

IN THE
Supreme Court of the United States
OCTOBER TERM, 1982

SHEARN MOODY, JR.,
Petitioner,
v.
DAVID C. MEYERS, *et al.*,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

MOTION FOR LEAVE TO FILE A BRIEF *AMICUS CURIAE* OF THE WASHINGTON LEGAL FOUNDATION AND BRIEF OF *AMICUS CURIAE* THE WASHINGTON LEGAL FOUNDATION IN SUPPORT OF AFFIRMANCE

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MOTION OF THE WASHINGTON LEGAL FOUNDATION FOR LEAVE TO FILE A BRIEF *AMICUS CURIAE*

The Washington Legal Foundation hereby moves this Court pursuant to Supreme Court Rules 36.1 and 42.2(b), for leave to file the annexed brief *amicus curiae* in support of the Petition for Writ of Certiorari in the above captioned proceeding. Consent to the filing of this brief has been granted by counsel for petitioner. Counsel for respondent has been contacted and has withheld consent.

The Washington Legal Foundation (WLF or Foundation) is a national non-profit public interest law center that engages in litigation and the administrative process in matters affecting the broad public interest. WLF has more than 85,000 members throughout the United States whose interests the Foundation represents.

WLF participates in and has devoted a substantial portion of its resources to cases relating to government regulation, judicial procedure, and constitutional law involving the rights of citizens and businesses. WLF has appeared in the United States Supreme Court on many occasions as *amicus curiae*. *See, e.g., Consolidated Edison Co. of New York v. Public Service Commission of the State of New York*, 447 U.S. 530 (1980); *United Steel Workers v. Weber*, 443 U.S. 193 (1979); *Carbon Fuel Co. v. United Mine Workers*, 442 U.S. 939 (1979); *Personnel Administrator of Mass. v. Feeney*, 442 U.S. 256 (1979); *Parklane Hosiery Co. v. Shore*, 439 U.S. 322 (1979); and *Federal Trade Commission v. Standard Oil Co. of California*, 449 U.S. 232 (1980). More significantly, WLF filed, and the Court accepted over opposition, a brief *amicus curiae* in support of the petition for writ of certiorari in *Moody v. Forresster*, No. 80-1235 (US. filed Feb. 20 1981), *cert. denied*, 450 U.S. 1026 (1981), and *Moody v. State of Alabama ex rel. Tharpe Forresster*, No. 82-740 (U.S. filed Oct. 28, 1982), *cert. denied*, 51 U.S.L.W. 3612 (U.S. Feb. 22, 1983). These cases arose out of the same facts and circumstances as the instant one although the issues here are different. In addition, WLF has recently published a relevant monograph, F. Newman, *Insurance: Is It Overregulated?* (1982).

WLF believes that as a matter of law and policy, the Fifth Circuit's decision merits this Court's review and reversal not only for the seriousness of its legal errors but for the extremely adverse consequences that such decision will have on not only the petitioner, but also the

insurance industry, regulated industries as a whole, and consumers.

WLF submits that the decision below is clearly contrary to the public interest and accordingly, requests that it be permitted to participate as *amicus curiae* in this matter.

Respectfully submitted,

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July 20, 1983

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INTERESTS OF THE *AMICUS CURIAE* WASHINGTON LEGAL FOUNDATION

The interests of *amicus curiae* Washington Legal Foundation (WLF or Foundation) are set forth in the foregoing motion for leave to file a brief *amicus curiae.*

STATEMENT OF THE CASE

In the interests of judicial economy, *amicus* hereby adopts by reference the Statement contained in the Petition for Writ of Certiorari at 2-6. Nevertheless, *amicus* believes it is warranted and useful to recount certain facts that highlight the significance of the issues to be resolved.

Petitioner incorporated Empire Life Insurance Company ("Empire") in 1963 in the State of Alabama and became its president, board chairman, and majority shareholder. Subsequently, he transferred to Empire a 40 per

cent share of his life interest in the Libbie Shearn Moody Trust. The valuation of this asset of Empire, as well as any other asset of any insurance company, is the statutory responsibility of the appropriate state Department of Insurance. The primary purpose of the asset valuation by the Department of Insurance is to assure that the insurance companies are economically sound to protect policyholders. The asset valuation process and the judicial review of that process are the underlying issues in the case at bar.

In this case, the Superintendent of Insurance for Alabama, in accordance with his statutory authority, had placed the following values on the life interest asset of Empire:

1964: $ 5,813,440
1965: $14,213,440
1969: $14,213,440
1972: $ 4,250,000

Because of the $14.2 million valuation placed on the asset in 1965, Empire acquired interests in other companies and expanded its business. These mergers and acquisitions were reviewed and approved by the Alabama Department of Insurance. To this day, there have never been any direct challenges, either administratively or judicially, to the orders of the Department of Insurance placing the $14 million value on the asset or approving the mergers.

However, because of the devaluation of the life interest by the Department of Insurance in 1972 to an amount of $4,250,000, Empire was immediately declared to be insolvent under statutory accounting principles and placed into receivership on June 29, 1972. Shortly thereafter, attorneys were hired by the Receiver at an hourly plus contingent fee to be paid from a $2 million fund set aside from Empire's assets and from the recovery of any claims prosecuted.

The instant lawsuit was filed by the Receiver on behalf of Empire against its founder Shearn Moody in June, 1974 alleging that Mr. Moody violated federal securities law and mismanaged the company because the acquisitions he made *before* 1972 were unreasonable because the asset, upon which the acquisitions were made, should not have been valued at $14.2 million even though it was so valued by the Superintendent of Insurance. Thus, the present Receiver contends that the revaluation of life interests to $14.2 million by the former receiver was erroneous and that Mr. Moody should be personally liable as a result.

The case was tried in December, 1976 and although the jury found that the policyholders suffered *no* injury because of Mr. Moody's alleged mismanagement, they awarded damages against him for over $6 million. On May 29, 1979, the district court entered judgment against petitioner for $6,319,000 with pre-judgment interest at 6 percent accruing from at least July 1, 1972, the date of the Receivership. Pet. App. 78. Thus, the amount accrued to date exceeds $10 million, not a cent of which is owed to any policyholders of Empire since all obligations to pay them have already been satisfied. The Court of Appeals affirmed, creating out of thin air a new rule of insurance law that, notwithstanding the regulation of the insurance industry by the states and the statutory responsibilities of insurance commissioners in valuating assets and approving mergers, a federal court can *de novo* make its own valuations of assets and hold company officials personally liable for not operating a business on the basis of those judicially determined valuations.

The result of this case is that Mr. Moody has had his once valuable interest suddenly declared to be almost worthless and his company thereby declared statutorily insolvent. The assets of his company, once transferred to the Receiver, were then used to hire counsel at an hourly plus contingent fee rate to sue Mr. Moody and

hold him personally liable retroactively for over $6 million. Further, the alleged injury stemming from acquisitions approved by the proper state authorities in the first place, run not to any company policyholder, but presumably to the company itself which Mr. Moody founded.

REASONS FOR GRANTING THE WRIT

The decision of the court of appeals is truly mind-boggling. Not only is it a gross miscarriage of justice for the petitioner, but the decision does great violence to the concept of federalism, runs roughshod over the legal principles enunciated by this Court in *Erie Railroad Co. v. Tompkins*, 304 U.S. 64 (1938), conflicts with decisions in other circuits, will open the floodgates to litigation in federal courts already straining from overloaded dockets, and has the real potential for creating great economic havoc with the multibillion dollar insurance industry to the detriment of consumers and the economy.

Amicus submits that the Fifth Circuit "has so far departed from the accepted and usual course of judicial proceedings, or so far sanctioned such a departure by a lower court, as to call for an exercise of this Court's power of supervision." Supreme Court Rule 17.1(a). *Amicus* further submits that the underlying legal issues of this case are appropriately postured for this Court's review after a decade of litigation, and thus especially warrant this Court's consideration.

I. THE DECISION BELOW IMPERMISSIBLY PERMITS FEDERAL COURTS TO INTERVENE INTO STATE REGULATORY MATTERS AND IS NOT IN THE PUBLIC INTEREST

The Fifth Circuit's decision completely ignored the rights and duties of the states, through their respective insurance commissioners and local courts, to regulate insurance companies. Federal legislation policy recognizes that the regulation of the business of insurance by the states "is in the public interest." 15 U.S.C. 1011

(McCarran-Ferguson Act). It is also "in the public interest" that the federal courts, as courts of limited jurisdiction, should in the first instance abstain for exercising jurisdiction that has the effect of collaterally attacking decisions made by state regulatory agencies. *Burford v. Sun Oil Co.*, 319 U.S. 315, 318 (1943); *Allstate Insurance Co. v. Sabbagh*, 603 F.2d 228 (1st Cir. 1979); *Smith v. Metropolitan Property & Liability Insurance Co.*, 629 F.2d 757 (2d Cir. 1980).

In the second instance, if the federal courts are allowed to exercise their limited jurisdiction and intrude into matters of state regulation, they are required to apply state law to the state law claims. *Erie Railroad Co. v. Tompkins*, 304 U.S. 64 (1938). In this case, however, the Fifth Circuit failed to pay even lip service to the laws of Texas or Alabama regarding the valuation of assets of insurance companies, and instead engaged in lawmaking of its own. By doing so, the court recklessly cast aside fundamental principles of federalism and comity, as well as basic principles of the finality of agency decisions by permitting a collateral attack on those decisions.

As indicated in petitioner's writ of certiorari, collateral attacks on an agency's decision, such as the attack here on the decision valuating the asset of Empire at $14.2 million, are clearly forbidden under Texas and Alabama law. *See* Petition at 13, 18, n. 19. Not surprisingly, other states have similar prohibitions against collateral attacks. Consequently, federal courts, when faced with questions such as those presented here, have either abstained from exercising their jurisdiction at all, or if they do exercise jurisdiction they apply state law which invariably prohibits collateral attacks on the decisions or orders of the state agency.

As stated, for example, in *Preferred Risk Mutual Insurance Co. v. Manchester Insurance Indemnity Co.*, 467

F.2d 1230 (7th Cir. 1972), the federal court, citing relevant state law, stated:

> "[The Director of Insurance] is vested with authority to determine whether or not a company is complying with the Statute. . . . Being an executive officer his acts, within the scope of his authority, are not and should not be subject to review by the Courts. Any other rule might result in the Courts substituting their judgment for that of the Director."

467 F.2d at 1233, *quoting Barber, People ex rel. v. Hargreaves*, 303 Ill. App. 287, 25 N.E.2d 416, 420 (1980). Since the $14.2 million valuation had not been directly attacked, it should have been accepted by the lower courts as reasonable. As stated by Professor Davis:

> [W]hen a statutory method of review of administrative action is prescribed by statute, that method probably is always deemed a direct attack. Normally, a challenge of administrative action by injunction, declaratory judgment, certiorari, or mandamus, is deemed a direct attack when no statutory method of review is prescribed. Proceedings that courts have classified as *collateral include suits against private parties for damages*. . . .

2 K. DAVIS, ADMINISTRATIVE LAW TREATISE 18.10 at 613-14 (1958) (emphasis added).

And since the laws of Texas or Alabama prohibit collateral attacks such as that here, the asset valuation must be accepted as binding. Thus, as further noted by Professor Davis:

> Whenever a court holds that an administrative determination is invulnerable to collateral attack the result may be phrased in terms of res judicata: the administrative determination is res judicata for purposes of the proceeding in which the collateral attack is made.

Id. at 612.

The adverse effect of this novel decision on the insurance industry has the real potential of approaching catastrophic proportions. Since the formation of the first life insurance company in Philadelphia in 1759, the number of such companies has slowly grown to approximately 2,000. American Council of Life Insurance, 1982 LIFE INSURANCE FACT BOOK 88 (hereinafter "1982 FACT BOOK")[1] These life insurance companies have assets that have been valued in excess of $525 *billion* and employ an estimated 1.9 million persons. Some 150 million policyholders in the country own some form of life insurance. It should be remembered that these figures only reflect the characteristics of the life insurance industry and do not include the multi-billion-dollar automobile, casualty, health, and other liability insurance industries.

The primary responsibility for regulation of an industry of this magnitude has been carefully developed by the states over the last two centuries as recognized by the U.S. Congress and this Court. *See SEC v. National Securities Inc.*, 393 U.S. 453, 458-59 (1969). Each state has an appropriate insurance commissioner or superintendent whose statutory responsibility is to ensure that the insurance companies comply with state law regarding their financial affairs.

One of the primary duties of such an agency official is to determine the value of the assets held by the insurance companies to ensure their economic health for the benefit of the policyholders. In this latter respect, it should be noted that life insurance companies have assets of over $40 billion in the miscellaneous asset category, in which the life interest in question here would appear to fall.

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[1] Texas ranks second among the states with the number of life insurance companies domiciled there at over 200. The first is Arizona with over 527. Third is Louisiana at 100. Alabama has 33 life insurance companies, more than twice the number of New Jersey (16), Virginia (14), or Maryland (12), 1982 FACT BOOK at 89.

1982 FACT BOOK 87. Such assets range from real estate ventures to oil, mineral, and timber rights. The value to be placed on these assets, like the life interest in the case at bar, is, as petitioner notes, a mixture of art and science developed by the expertise of those whose job it is to make such valuations, namely, the state insurance commissioners as opposed to federal courts.

After two centuries of reliance on state commissioners' decisions by those affected by the determinations of asset valuation, the Fifth Circuit upsets that reliance and replaces it with extreme uncertainty and instability by exposing insurance company officials to personal liability *retroactively* should a federal court or jury second-guess the determinations of the state commissioner. What the Congress expressly forbade the federal government to do directly by passage of the McCarran-Ferguson Act, the Fifth Circuit has impermissibly sought to do indirectly. By changing the "rules of the game," the Fifth Circuit's decision can only lead to a situation that will harm the policyholders and consumers.

It is clearly in the interests of the consumer for insurance companies to grow and thrive. The more insurance companies there are, the better the competition. As insurance companies are able to expand and acquire income producing assets, the less reliance there is by the company on insurance members as a source, of income, and hence, the greater ability to offer lower cost premiums to the consumer.[2]

If, however, insurance companies can no longer rely on the finality of assets valuations by the state commissioner, but must constantly be concerned that a federal court could years later rule that company officers are personally liable for erroneous asset valuations, the

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[2] Approximately 70 percent of the life insurance companies' income is derived from premiums. Almost 30 per cent is from net investment earnings and other income. 1982 FACT BOOK 61.

prospect of growth is dim at best. Insurance companies would be reluctant to grow or acquire those assets whose valuations may be difficult to determine and subject to change. New companies and investors would be deterred from entering the insurance market because of the unknown liability factor and instability brought about by the intrusion of federal courts into this area. The granting, renewal, and revocation of insurance licenses, certifications of the proper level of capital surplus, compliance with set insurance rates, or the value of a company's holding suddenly become subject to change at any time by the filing of derivative money damage suits against management.

II. THIS COURT SHOULD GRANT REVIEW AND ORDER THE CASE DISMISSED FOR LACK OF JURISDICTION

Amicus supports petitioner's argument that the decision below unjustly permits a duplicative or "windfall" recovery inconsistent with this Court's decision in *Bangor Punta Operations, Inc. v. Bangor & Aroostook Railroad Co*, 417 U.S. 703 (1974) Pet. at 24. If the decision below is allowed to stand, Mr. Moody would be found to be liable for his own loss. A closer analysis of that issue, however, reveals that the respondent is not the real party in interest and that, accordingly, a serious question is presented whether the court below had federal jurisdiction in the first place. *Amicus* submits that both diversity and pendent jurisdiction are lacking.

A. No Diversity Jurisdiction

As noted by petitioner in his petition at (i), "Parties To The Proceedings," the only surviving suit out of the three brought against petitioner is the one filed by John G. Bookout as receiver of Empire against Shearn Moody, Jr., a resident of Texas. Consequently, diversity must stand or fall as of the time that suit was filed, June 28, 1974, and not the other two suits.

However, the Receiver named in the suit is not the real party in interest. As noted by the Fifth Circuit, the Alabama receivership court approved a bulk reinsurance agreement of Empire with Protective Life Insurance Company. Pet. App. 1. As noted by petitioner, "[i]t is Protective, and Protective alone, that the judgment will enrich." Pet. at 26. In addition to Protective gaining the windfall, *amicus* notes that the attorney for respondent, Mr. William Wright, a Texas citizen, has an employment contract dated November 13, 1972, filed in the Alabama receivership court granting him an hourly rate *plus* a one-third interest in the recovery from this action. Although denominated a "contingent fee," there was no financial risk to him since he was and is being compensated from a $2 million fund set aside from the assets of Mr. Moody's allegedly insolvent company. In reality, the respondent assigned away all his interest in this case, and is nothing more than a conduit for a windfall going to Protective Life and Mr. Wright. The nondiverse party is Mr. Wright of Texas. *See Anderson v. Watt*, 138 U.S. 694 (1891); *American Foundation, Inc. v. Mountain Lake Corp.*, 454 F.2d 200 (5th Cir. 1972).

Consequently, *amicus* submits that the lower court lacks diversity jurisdiction.

B. No Pendent Jurisdiction

At the trial court level, petitioner challenged the propriety of the district court's exercise of pendent jurisdiction. Motion to Dismiss the Original Complaint at 15 (filed Sept. 30, 1975). The subsequent judgment by the district court never clarified the issue of whether it was exercising pendent jurisdiction. Mr. Moody's brief filed at the appellate level in support of his motion to vacate the district judgment at 12-17 provides further compelling reasons why the exercise of pendent jurisdiction, if it indeed were exercised, was improper. This is-

sue was never waived either at the trial or appellate level by petitioner and merits this Court's review to ensure that federal jurisdiction is being properly involved in such a case as this with its significant impact.

Without discussing this issue at length, *amicus* notes that the essence of the argument is that no real federal securities 10b-5 claim was properly made, since one or more elements of the claim are necessarily lacking. Indeed, the Fifth Circuit's opinion is grounded only on liability under the state claims. For example, if as it appears, the proximate cause of the damages was the acquisition program by Empire, then fraudulent Section 10b-5 acts complained of were the cause of the injury, which is too remote and insufficient to find liability. If proper causation did exist, the element of reliance disappears since petitioner could hardly defraud himself or his alter ego, Empire. If the minority shareholders stand in the place of the corporation, then the statute of limitations bars a 10b-5 claim since the last acquisition program took place over four years before this action was filed.

Even if a substantial 10b-5 claim were presented, pendent jurisdiction was improper since the common law fraud claims were, as even admitted by respondent below, "virtually identical" to the facts of the 10b-5 claim. *Amicus* submits that it is an improper use of Federal pendent jurisdiction to use the identical operative facts to serve the simultaneous purpose of supporting common law and federal claims. *See Santa Fe Industries v. Green*, 430 U.S. 462, 479 (1977); *Herpick v. Wallace*, 430 F.2d 792, 809 (5th Cir. 1970).

The exercise of pendent jurisdiction similarly violates the principle, as noted in the first part of this brief, that the valuation of the asset in question which was properly made by the appropriate state official should not be subject to this novel and belated collateral attack.

CONCLUSION

For the foregoing reasons and those stated in the Petition, *amicus* submits that this case especially warrants the granting of the petition for a writ of certiorari.

Respectfully submitted,

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